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STATE OF THE ECONOMY AT MIDYEAR

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDREDTH CONGRESS

FIRST SESSION

JUNE 30 AND JULY 1 AND 2, 1987

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STATE OF THE ECONOMY AT MIDYEAR

TUESDAY, JUNE 30, 1987

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senator Sarbanes and Representatives Solarz, Wylie, and McMillan.

Also present: Judith Davison, executive director; Richard F Kaufman, general counsel; and Dale Jahr, Jim Klumpner, and Dan Bond, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order.

Today we start the first of a series of hearings on the American economy at midyear. The purpose of these hearings, which will extend over this week, is to gather evidence and opinion about the current performance of the American economy and its probable course over the next 6 months. Such evidence must play an important role in informing congressional action on a wide range of issues in the coming months.

Much of the evidence readily available suggests that the task of understanding the current state of the economy and predicting its future will not be an easy one. That's not an unusual situation, I might observe. The conventional indicators present no clear or uniform picture of the economy, and the conflicting signals derived from different sources pose a very significant challenge to economic policy.

The first quarter GNP figures, for example, show an apparently strong economy with real growth in output at a healthy 4.8 percent. But at the same time, most analysts attributed this growth to excess production in the automobile sector and unsustainable inventory accumulations elsewhere in the economy. The consensus estimate of 50 of the Nation's top economic forecasters is for GNP growth in 1987 to be only 2.4 percent.

For the first quarter of this year, consumer spending fell 1.1 percent, with consumption of durable manufactured goods falling a startling 19 percent. Since consumer spending has been the main force sustaining our current recovery, this apparent turnaround has potentially serious implications.

Other indicators also point to problems with the current recovery. In the first quarter, real nonresidential fixed investment fell

almost 10 percent and real residential investment fell almost 5 percent. Housing starts are 10 percent below their level for a similar period in 1986. And real disposable personal income has fallen for the past 3 months in a row.

The trade deficit appears to have "turned a corner" and is unlikely to continue to place a drag on domestic economic growth. But whether it will improve quickly enough to be a major stimulant to growth remains an unanswered question.

These indicators suggest an economy which continues to move forward, but uncertainly at a slowing pace. They also suggest an economy with weaknesses and problems for the future which ought to be a focus of concern for economic policy.

In approaching the question of future economic policy it is important not to drift into the kind of complacency which may have led to the problems in the first place. The current huge budget deficits stem from a complacent belief that massive supply-side tax cuts would stimulate a burst of economic activity that would more than make up for foregone revenues. The current huge trade deficits grew out of a complacent belief that an overvalued dollar was a national asset rather than a national problem.

Today's equivalent complacency would suggest that our current problems will either solve themselves or are not serious enough to warrant public attention. Some argue, for example, that the trade deficit will decline sufficiently over time on its own accord, and that current economic growth under 3 percent is adequate for national needs. To accept such assertions confidently is to risk aggravating further the problems now confronting the economy.

The trade deficit is not getting any worse, but that is not good enough. Five years of record trade deficits have left us a legacy of some $264 billion in net external debt, which weakens our influence in the world and diminishes our ability to manage our own economy. We need a forward-looking strategy to turn today's trade deficits into strong trade surpluses if we are to relieve ourselves of the burden of this debt.

The same is true with respect to economic growth. There has been some talk of late about accepting a rate of economic growth in the 2 to 3 percent range as adequate. But accepting such a target means condemning the United States to a low-growth, low-productivity economy. Accepting the low-growth road means settling for less than we are capable of achieving; this kind of complacency about growth should not be a substitute for a thoughtful and comprehensive national economic policy.

With these considerations in mind, I'm pleased now to turn to our witnesses for their views on the economy and economic policy at midyear. We will hear first from Beryl Sprinkel, Chairman of the President's Council of Economic Advisers. Mr. Sprinkel will be followed by a panel of private sector witnesses.

Before I yield to Congressman Chalmers Wylie, I want to take just a moment to pay tribute on behalf of the Joint Economic Committee to two very distinguished economists, Walter Heller and Arthur Burns, both of whom died since the last time this committee met. Both, I think, made extraordinary contributions to our nation. They were of opposite political persuasions, but the debate and dialogue between the two of them represented the best of

American democracy. That debate was a measure of how our politics should be practiced. Walter Heller and Arthur Burns differed in their perceptions and how they weighed matters, but they were always reasonable. They understood that reasonable people could differ, tolerantly and respectfully, and I think they elevated the national dialogue with respect to economic policy and made very significant contributions to our nation.

Congressman Wylie.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Thank you very much, Mr. Chairman. I wish to associate myself with your remarks about the late Walter Heller and Arthur Burns. Some of the great moments that I've had in Congress were had in listening to these great gentlemen and gaining from their expertise as to the state of the economy, and they will be missed in our future deliberations.

I wish to commend you, Mr. Chairman, for your leadership in organizing this week's timely and important series of hearings at midyear 1987.

I join you, Senator, and the other members in welcoming the witnesses today. I am pleased that Mr. Sprinkel is our leadoff witness, whose insights and observations are always appreciated. I look forward to your testimony and the testimony of the entire panel.

At midyear 1987, we find the economy, like "Old Man River," just keeps rolling along. We have just ended the 55th month of economic expansion, only 3 months shy of the longest peacetime expansion, on record. In October, we will break that enviable record and, furthermore, according to the Blue Chip Consensus of Forecasters, we are likely to shatter the record, not just limp past it.

Our current economic expansion is not perfect, but none ever are. But there seems to me to be no reason to be pessimistic about the future of our economy. We have a great deal to brag about. Back on a foundation of sound economic principles and a rekindling of the free enterprise spirit, our nation is poised for even greater growth.

Let's look at economic performance during this expansion and during the past dozen years.

First, we have made dramatic improvements in halting inflation and reducing unemployment. Remember the misery index. We have a chart here to show the misery index. It's comprised of the inflation rate and the unemployment rate. In 1986, it was at its lowest level since the index was invented, at 8.9 percent. In 1980, it was 20.6 percent.

Let's look at the gross national product. It's been climbing 55 months without losing ground once. Over the past 4 years, inflation-adjusted GNP grew 16 percent. Compare that to the 4 years before 1982, when it grew one-tenth that rate.

How about the GNP growth being translated into income for American people? Just fine, thank you, and here's another chart to prove that.

Real per capita disposable income has risen steadily, gaining 10.8 percent from 1982 to 1986. This income measure was slightly negative from 1978 to 1982. Employment gains have been most impres-

sive, too. Over 10 million jobs were created in 4 years. Only 3 million were created during the stagflation years.

Finally, this expansion has witnessed a renewed confidence in investment, and that promises a brighter future indeed. Real gross private domestic investment has hovered around $650 billion annually during the past few years, a jump of $200 billion from the 1982 level. Over the past 4 years, investment has jumped 50 percent, a big turnaround from a 22-percent decline since 1978 to 1982.

These few charts are just the beginning of the good news we have to celebrate.

By some strange twist, we are about to break an economic growth record at the same time we are commemorating the bicentennial of our Constitution. Are they related? Maybe it's just a coincidence. But it is undeniable that the United States has the world's largest and strongest economy because the Founding Fathers built sound economic principles into the Constitution.

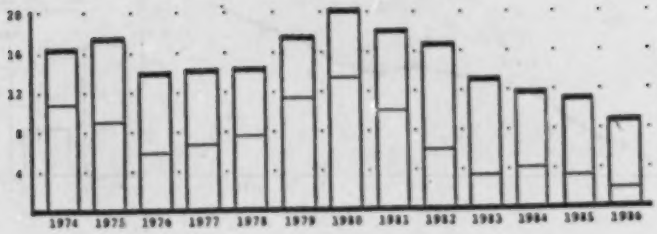
The renewal of the free enterprise and entrepreneurship has made an invaluable contribution to the current economic expansion. Continuing this spirit can only lengthen it.

Again, thank you very much. Mr. Sprinkel, I look forward to your testimony.

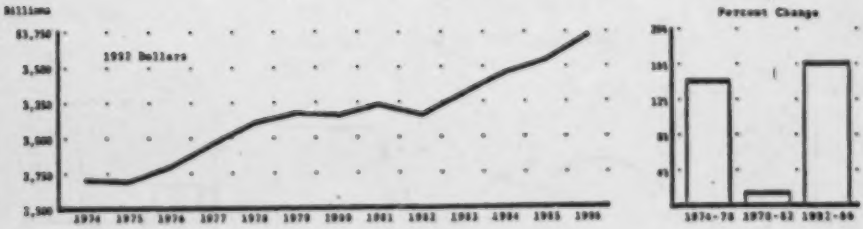
[The charts referred to by Representative Wylie follow:]

MISERY INDEX

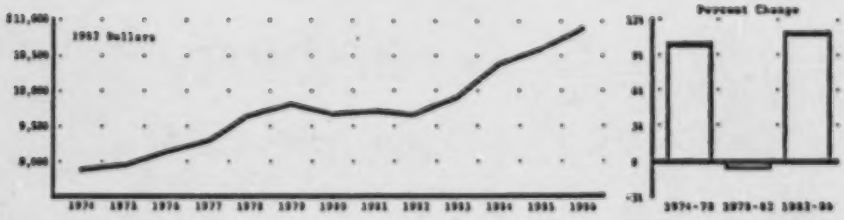
CPI + Unemployment Rate



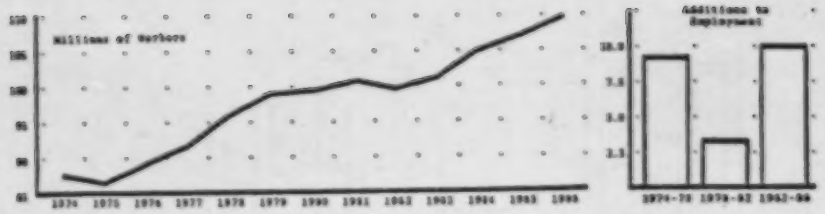
REAL GROSS NATIONAL PRODUCT



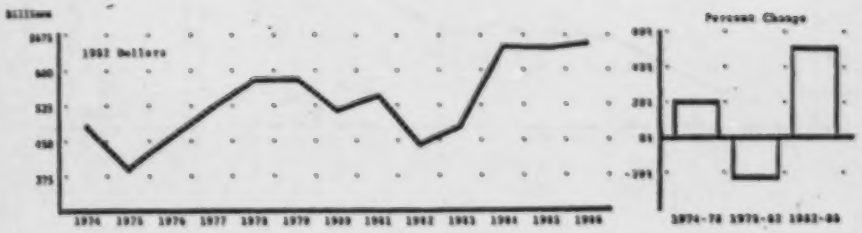
REAL PER CAPITA
DISPOSABLE PERSONAL INCOME



CIVILIAN EMPLOYMENT



REAL GROSS PRIVATE DOMESTIC INVESTMENT



Senator SARBANES. We are ready to hear from you, Mr. Sprinkel. Thank you very much for appearing. We look forward to your testimony.

STATEMENT OF HON. BERYL W. SPRINKEL, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SPRINKEL. Chairman Sarbanes and distinguished members of the committee, it is, as always, a pleasure to be here to testify on the outlook for economic activity, inflation, and employment. Mr. Chairman, I would like to join you in honoring the memory of two of my good friends and predecessors, Arthur Burns and Walter Heller.

Now I would like to brief the detailed testimony if I may that I will submit for the record.

Senator SARBANES. Your full statement will be included in the record.

Mr. SPRINKEL. The U.S. economy, as Congressman Wylie has indicated, is ending the 55th month of the economic expansion. In October of this year, it will become the longest peacetime expansion of this century and the second largest of the postwar era.

The initial steep fall and subsequent stability of inflation, the general declines in interest rates, and the surge in employment, especially in the higher paying occupations, are notable features of the current economic expansion.

However, the deterioration of the U.S. trade balance has hampered real GNP growth in recent years, even as real spending continued to advance at a solid pace. Clearly, prospects for an acceleration of economic growth in 1987 and 1988 will depend importantly on the progress that is made in shrinking the U.S. trade deficit.

Fortunately, the economy is in the midst of a necessary shift in the composition of growth. In particular, real total domestic spending has begun to grow more slowly than real GNP and a shrinking net export deficit is now contributing to, not retarding, economic growth.

As I shall now explain, the available evidence suggests that prospects are good for an acceleration of real GNP growth in 1987 and a continuation of economic expansion into 1988.

Compared with the same quarter during the previous year, the growth of real consumption spending fell from 4.5 percent in the third quarter of 1986 to 4 percent in the fourth quarter, and to 2.8 percent in the first quarter of 1987, while the personal savings rate rose from a 40-year low of 2.5 percent in the fourth quarter of 1986 to a still insufficient 3.5 percent in the first quarter of 1987.

A continuation of more modest growth in consumption is likely as households attempt to rebuild savings rates to more normal levels.

As a result of the depreciation of the dollar that has taken place over the past 2-plus years, we see solid evidence that the next export deficit is starting to shrink and contribute importantly to, not hamper, economic growth. The real net export deficit declined by $15.3 billion at an annual rate in the fourth quarter of 1986 and $14.3 billion in the first quarter of 1987.

Especially encouraging is the fact that exports of goods and services in volume terms have been growing at a rapid 13.9 percent annual rate since the second quarter of 1986 and that import volumes have actually declined in each of the last two quarters. As a result, real net exports of goods and services have contributed roughly 1.6 percentage points at an annual rate to real GNP growth in each of the last two quarters.

After exhibiting exceptional strength during the first 3 years of the present expansion and setting records as a share of real GNP in both 1984 and 1985, real business fixed investment weakened slightly in 1986. Now this was due in part to a collapse of investment in the oil and gas sectors and perhaps also to uncertainty concerning the final provisions of the tax reform legislation that was being debated in Congress for most of the year.

Rising corporate profits, improved international competitiveness, and export sales and a surging stock market should contribute to some strengthening of real business fixed investment this year. In this regard, a recently released survey by the Commerce Department reports that businesses expect to increase real capital spending by 2.8 percent in 1987.

Taking all cases together, real GNP growth should accelerate to somewhat more than 3 percent in 1987 and 1988 on a fourth quarter to fourth quarter basis. During the first quarter of this year, real GNP grew at a revised 4.8 percent annual rate. A sizable and largely anticipated increase in business inventories, as well as the previously discussed improvement in real net exports accounted for the surge in first quarter real GNP. In coming quarters we expect inventory investment to moderate, consumption and investment spending to resume growth after declining slightly in the first quarter relative to the fourth quarter of 1986, and real net exports to continue to contribute to growth.

Economic growth should benefit from the low tax rates and elimination of loopholes that will result when tax reform is fully phased in in 1988. Faster economic growth and a projected decline, for the first time since 1973, in real Federal outlays should result in a substantial decline in the Federal budget deficit in fiscal 1987.

During the first 5 months of this year, total employment has increased by more than 1.7 million persons and the unemployment rate has fallen to 6.2 percent. As the administration completes the midsession review of the economic outlook, it is not unlikely that the present official forecast of a 6.5 percent unemployment rate for the fourth quarter of 1987 will be revised down.

With regard to recent concerns that a resurgence of inflation is likely, any assessment of the inflation outlook must take into account the stance of monetary policy as well as the recent rebound in energy prices, the increase in relative import prices resulting from the depreciation of the dollar, and movements in wage rates and profit margins that play critical roles in determining the underlying inflation rate.

Money growth in 1985 and 1986 was quite rapid by historical standards. However, rates of monetary expansion that previously would have implied a resurgence of inflation appears to have been necessary in recent years to satisfy an increase in the demand for money balances relative to income. Although the nature of the

change in money demand is not fully understood at this time, no plausible assessment of the shift in money demand would imply a permanent need for such rapid money growth in the future.

Since the end of last year, the Federal Reserve has slowed the growth of monetary aggregates, especially M2. Specifically, while M2 grew at 8.9 percent between the fourth quarter of 1985 and the fourth quarter of 1986, it grew at only a 1.9 percent annual rate between January and May 1987. The tightening of monetary policy is also apparent in the behavior of the Federal funds rate. In May 1987, the funds rate averaged 6.9 percent, a full percentage point above its level in the fall of 1986.

The tightening of monetary policy in 1987 is consistent with the generally recognized need to reduce money growth below the very rapid rates recorded in 1985 and 1986. I emphasize, however, that such a dramatic slowdown of money growth, if continued a few more quarters, could place the continuation of reasonable growth of real output and employment at risk.

Although the CPI rose at a 5.6 percent annual rate during the first 5 months of 1987, well above the 1.1 percent annual rate recorded last year, most of this increase in the measured inflation rate is not properly attributable to monetary policy. The sharp decline in energy prices early in 1986 and the subsequent rebound late in the year and in 1987 account for most of this difference in inflation rates. Excluding energy, the CPI rose at a 3.8 percent annual rate in 1986 and at a 4.8 percent annual rate for the first 5 months of 1987. Within several months, the impact of the rebound in energy prices should be passed through to the CPI.

Higher prices of imported products associated with the decline in the foreign exchange value of the dollar have likely also contributed to the recent uptick in the measured inflation rate. Specifically, the Bureau of Labor Statistics index of nonfuel import prices was rising at a 10.2 percent annual rate during the first 3 months of 1987. The impact of the weaker dollar and higher import prices on the U.S. inflation rate will probably continue to be relatively modest, however, because imports have a relatively small weight in the CPI. Moreover, foreign profit margins widened considerably during the period of recent dollar appreciation, and the ultimate passthrough to the CPI of the dollar's recent depreciation may be less than expected from historical relationships.

Based upon the above considerations, it is my view that concerns that the U.S. economy is locked into a resurgence of inflation above that recorded during the first 3 years of the current expansion are exaggerated. The recent uptick in inflation above the 4 percent rate is largely due to temporary, supply-side disturbances. A sustained increase in the inflation rate is likely only if the inflationary process begins to affect domestic costs, wage rates, and profit margins. Under an appropriate monetary policy, this should not happen provided that workers and firms continue to recognize the nature of the international competitive situation.

While the near-term outlook for economic growth, inflation, and the trade balance is encouraging, three challenges must be met if the U.S. economy is to continue to enjoy sustained growth with low inflation and a shrinking trade deficit.

First, the Federal budget deficit must be reduced and it should and likely will ony be reduced by restraining the growth of Federal spending. A general tax increase that abandons tax reform is not the solution to the budget dilemma. A general tax increase would hamper growth and inhibit improvements in productivity. Furthermore, a general tax increase does not eliminate the source of the budget deficit: growth in government spending that far outpaces the growth of the economy in a period of economic expansion. A substantial reduction in the Federal budget deficit will be achieved in fiscal 1987 as a result of economic growth and a reduction in real Federal outlays. We can and must make similar progress in reducing the Federal budget deficit in 1988 and in later years.

Second, protectionism must be resisted. Our trade deficit is not primarily a product of narrow commercial policy actions taken against the United States. While it is important that we continue to strive to open foreign markets for U.S. exports, significant future reductions in our trade deficits will depend upon our ability to reduce the budget deficit and the efforts of our major trading partners to increase internally led growth.

Our international cost competitiveness declined during the first half of the 1980's because of the appreciation of the dollar. This appreciation has now been substantially reversed and the relative cost competitiveness of U.S. producers has been largely restored. For example, in 1986, unit labor costs in manufacturing rose an average 27 percent in our industrial trading partners when measured in dollar terms. Unit labor costs in Japan rose an astounding 42.6 percent in dollar terms. By contrast, unit labor costs in the United States, again measured in dollars, actually declined.

As a result of this significant improvement in U.S. cost competitiveness, trade-sensitive industries of our trading partners now face a period of adjustment. This adjustment will undoubtedly increase protectionist pressures abroad. It would indeed be tragic if we encourage protectionism abroad just as the United States is set to enjoy a period of export-led growth.

The third challenge is to put in place policies that will contribute to a rising standard of living while improving our international competitiveness. That is the objective of the President's competitiveness bill, and it should be the aim of any trade legislation that is passed by Congress. The key to increasing our standard of living is increasing productivity. Instead of adopting a defeatist, protectionist response to our trade deficit, we should focus our energies on this positive approach to enhancing our international competitiveness and raising our standard of living.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Sprinkel follows:]

PREPARED STATEMENT OF HON. BERYL W. SPRINKEL

Chairman Sarbanes and distinguished members of the committee, it is, as always, a pleasure to be here today to testify on the outlook for economic activity, inflation, and employment. In my prepared testimony, I will emphasize three points. First, the expansion in output and employment that began in December 1982 continues, and prospects are good for an acceleration of economic growth and a significant reduction in our real net export deficit in 1987 and 1988. Second, the recent rise in the measured inflation rate reflects the temporary, and largely anticipated, effects of the rebound in energy prices and the increase in import prices associated with dollar depreciation. Third, achieving sustained growth with low inflation and a shrinking trade balance requires that we continue to reduce our budget deficit via spending restraint, avoid protectionism, and put in place policies that will enhance our standard of living while improving our international competitiveness.

The Current Economic Expansion

The U.S. economy is presently in the 55th month of economic expansion. In October of this year, the current economic expansion will become the longest peacetime expansion of this century, and the second longest expansion of the postwar era. Before I discuss the outlook for economic growth, inflation, and

employment, it will be useful to review briefly several features of the current expansion as it has progressed thus far.

The initial steep fall and subsequent stability of inflation and the general decline in interest rates that have characterized this expansion are important accomplishments of economic policy since 1980. In particular, after falling from over 12 percent in 1980 to less than 4 percent in 1982 (the trough of the 1981-1982 recession), inflation remained at or below 4 percent in each of the first three years of the current expansion and fell to 1.1 percent in 1986, largely as the result of the steep decline in world oil prices. Similarly, 3 month Treasury bill yields, which reached 15.5 percent in 1980, averaged less than 10 percent in 1983-1984, less than 7.5 percent in 1985, and in July 1986 fell (and still remain) below 6 percent for the first time since 1977. This stands in marked contrast to the experience of the 1960s and 1970s in which inflation and interest rates rose above previous cyclical peaks as economic expansion proceeded.

Employment growth has been exceptionally strong during the current expansion with over 13 million jobs created. Furthermore, in contrast to the claims made by some observers, most of these are full time jobs in the highest paying occupations. In particular, acccording to Bureau of Labor Statistics data on employment classified by occupation, more than 60 percent of the increase in employment during the current expansion has occurred in occupations paying more than $390 per week in 1986. Throughout the current expansion, the share of the working age population with jobs has continued to set new records, reaching

an all-time high of 62 percent in May, a month in which the unemployment rate was at 6.2 percent, the lowest in more than seven years.

The deterioration of the U.S. trade balance has been a disturbing feature of the present expansion. From a surplus equivalent to almost 1 percent of GNP in 1982, U.S. real net exports of goods and services declined sharply to a deficit of more than 4 percent of real GNP in 1986. As is by now widely, although, unfortunately, not universally understood, the surge in the U.S. trade deficit that has occurred during the first four years of the current expansion is primarily a macroeconomic phenomenon that has resulted from an historically unprecedented gap between national saving and investment, strong growth of private spending relative to that of other countries, and the erosion of U.S. cost competitiveness stemming from the substantial appreciation of the dollar that occurred between 1980 and early 1985.

Weaker than expected GNP growth in 1985 and 1986 resulted not from sluggish growth of domestic spending but instead resulted largely from a shift in domestic spending away from domestically produced goods to imports as well as sluggish growth in U.S. exports. For example, in 1986, total real spending by U.S. households, firms, and Federal, state, and local governments (total domestic demand) rose by 3.5 percent compared with an increase in real GNP of only 2.5 percent (on a year over year basis). The gap between real domestic demand and real GNP resulted in a nearly $40 billion deterioration in real net

exports, of which $35 billion was due to an increase in real, nonpetroleum merchandise imports. Clearly, prospects for an acceleration of economic growth in 1987 and 1988 will depend importantly on the progress that is made in shrinking the U.S. trade deficit.

The Outlook for Growth and Employment

Prospects are good for an acceleration of real economic growth in 1987 and a continuation of economic expansion into 1988. Moreover, it is likely that the U.S. economy will experience a necessary shift in the composition of growth. In particular, total domestic demand -- especially real consumption spending and Federal purchases -- should begin to grow more slowly than does real GNP, resulting in an increase in household saving and a substantial reduction (at least in 1987) in the Federal budget deficit. A shrinking net export deficit should contribute to real GNP growth as real exports of goods and services accelerate and real import growth moderates.

The available evidence indicates that this necessary shift in the composition of demand is beginning to take place. Compared with the same quarter during the previous year, the growth of real consumption spending fell from 4.5 percent in the third quarter of 1986 to 4 percent in the fourth quarter, and to 2.8 percent in the first quarter of 1987, while the personal saving rate rose from a forty year low of 2.5 percent in the fourth quarter of 1986 to a still-insufficient 3.5 percent in the first quarter of 1987. A continuation of more modest growth in

consumption is likely as households attempt to rebuild saving rates to more normal levels.

As a result of the depreciation of the dollar that has taken place over the past two years, we see solid evidence that the net export deficit is starting to shrink and to contribute importantly to, not retard, economic growth. The real net export deficit declined by $15.3 billion at an annual rate in the fourth quarter of 1986 and by $14.3 billion in the first quarter of 1987. Especially encouraging is the fact that exports of goods and services in volume terms have been growing at a rapid 13.9 percent annual rate since the second quarter of 1986 and that import volumes have actually declined in each of the last two quarters. As a result, real net exports of goods and services have contributed roughly 1.6 percentage points (at an annual rate) to real GNP growth in each of the last two quarters.

Recent trends in the volatile monthly trade statistics suggest that the trade deficit may be starting to shrink in dollar terms as well. The average monthly trade deficit fell from $14.9 billion in the third quarter of 1986 to $14.3 billion in the fourth quarter, to 13.7 billion in the first quarter of 1987, and to $13.3 billion in April. We expect to see, on average, continued improvements in the monthly trade deficit measured in dollars.

After exhibiting exceptional strength during the first three years of the present expansion and setting records as a share of real GNP in both 1984 and 1985, real business fixed investment weakened slightly in 1986. This was due in part to a collapse of

investment in the oil and gas sectors and perhaps also to uncertainty concerning the final provisions of the tax reform legislation that was being debated in Congress for most of the year. Rising corporate profits, improved international competitiveness and export sales, and a surging stock market should contribute to some strengthening of real business fixed investment in 1987. In this regard, a recently released survey by the Commerce Department reports that businesses expect to increase real capital spending by 2.8 percent in 1987.

Pulling all the pieces together, real GNP growth should accelerate to somewhat more than 3 percent in 1987 and 1988 on a fourth quarter to fourth quarter basis. During the first quarter of this year, real GNP grew at a revised 4.8 percent annual rate. A sizable, and largely anticipated, increase in business inventories as well as the previously discussed improvement in real net exports accounted for the surge in first quarter real GNP. In coming quarters, we expect inventory investment to moderate, consumption and investment spending to resume growth after declining slightly in the first quarter relative to the fourth quarter of 1986, and real net exports to continue to contribute to growth. Economic growth should benefit from the low tax rates and elimination of loopholes that will result when tax reform is fully phased in 1988. Faster economic growth and a projected decline (for the first time since 1973) in real Federal outlays should result in a substantial decline in the Federal budget deficit in fiscal 1987.

During the first five months of 1987, total employment has

increased by more than 1.7 million and the unemployment rate has fallen to 6.2 percent. As the Administration completes the mid-session review of the economic outlook, it is not unlikely that the present official forecast of a 6.5 percent unemployment rate for the fourth quarter of 1987 will be revised down.

The Outlook for Inflation

During the first four years of the current expansion, the rate of inflation remained at or below 4 percent, a remarkable record in light of the experience of the 1960s and 1970s. In recent months, however, the rate of inflation as measured by the consumer price index (CPI) has jumped, and concerns have been expressed that a resurgence of inflation is likely. The recent 150 basis point increase in long-term interest rates -- which have since fallen back by roughly 60 basis points -- reflects this concern. Any assessment of the inflation outlook must take into account the stance of monetary policy, as well as the recent rebound in energy prices, the increase in relative import prices resulting from the depreciation of the dollar, and movements in wage rates and profit margins that play critical roles in determining the underlying inflation rate.

By historical standards, the double-digit rates of M1 growth recorded in 1985 and 1986 were quite rapid. The medium run inflationary implications of such rapid money growth remain uncertain. Rates of monetary expansion that previously would have implied a resurgence of inflation appear to have been necessary in recent years to satisfy an increase in the demand

for money balances relative to income. Although the nature of the change in money demand is not fully understood at this time, no plausible assessment of the shift in money demand would imply a permanent need for such rapid money growth.

Since the end of 1986, the Federal Reserve has slowed the growth of monetary aggregates, especially M2. Specifically, while M2 grew 8.9 percent between the fourth quarter of 1985 and the fourth quarter of 1986, it grew at only a 4.3 percent annual rate between the fourth quarter of 1986 and May 1987. M1 increased 15.3 percent between the fourth quarter of 1985 and the fourth quarter of 1986, and rose at a 10.7 percent annual rate between the fourth quarter of 1986 and May 1987. Since January, the slowdown in money growth has been more pronounced, with M1 increasing at a 6.3 percent annual rate through May, and M2 at only a 1.9 percent rate. The tightening of monetary policy is also apparent in the behavior of the federal funds rate. In May 1987, the funds rate averaged 6.9 percent, a full percentage point above its level in the fall of 1986.

The tightening of monetary policy in 1987 is consistent with the generally recognized need to reduce money growth below the very rapid rates recorded in 1985 and 1986. I would like to take this opportunity to emphasize, however, that such a dramatic slowdown of money growth, if continued for several more quarters, could place the continuation of reasonable growth of real output and employment at risk.

Although the CPI rose at 5.6 percent annual rate during the first five months of 1987, well above the 1.1 percent annual rate

recorded in 1986, most of this increase in the measured inflation rate is not properly attributable to monetary policy. The sharp decline in energy prices early in 1986 and the subsequent rebound late in the year and in 1987 account for most of this difference in inflation rates. Excluding energy, the CPI rose at a 3.8 percent annual rate in 1986 and at a 4.8 percent annual rate for the first five months of 1987. Within several months, the impact of the rebound in energy prices should be passed through to the CPI. Barring further disturbances in the world oil market, this temporary cause of a higher measured inflation rate should be eliminated.

Higher prices of imported products associated with the decline in the foreign exchange value of the dollar have likely also contributed to the recent uptick in the measured inflation rate. Specifically, the Bureau of Labor Statistics index of non-fuel import prices was rising at a 10.2 percent annual rate during the first three months of 1987. The impact of the weaker dollar and higher import prices on the U.S. inflation rate, however, will probably continue to be relatively modest. Available empirical research suggests that a 10 percent depreciation of the dollar results in only about a 6 to 7 percent increase in import prices after a lag of up to two years, and imports have a relatively small weight in the CPI. Moreover, foreign profit margins widened considerably during the period of recent dollar appreciation, and the ultimate pass-through to the CPI of the dollar's recent depreciation may be less than expected from historical relationships.

Based upon the above considerations, it is my view that concerns that the U.S. economy is locked in to a resurgence of inflation above that recorded during the first three years of the current expansion are exaggerated. The recent uptick in inflation, above the 4 percent range, is largely due to temporary, supply-side disturbances. A sustained increase in the inflation rate is likely only if the inflationary process begins to affect domestic costs, wage rates and profit margins. Under an appropriate monetary policy, this should not happen provided that workers and firms continue to recognize the nature of the international competitive situation.

The Tasks Ahead for Policy

To review, the economy continues to perform reasonably well, and prospects are good for an acceleration of economic growth in 1987 and into 1988. Employment growth has been strong and the unemployment rate continues to decline. The deterioration of our trade balance has abated, and a surge in export volumes is contributing to growth. Production costs are well contained, and improved competitiveness is boosting corporate profits and sales and should result in an increase in investment. Tax reform should contribute to growth in 1988. Although inflation has picked up somewhat this year, most of this rise reflects one-time increases in the price level due to rising energy and import prices. The underlying inflation rate does not appear to have increased significantly.

These developments are indeed encouraging. However, three

challenges must be met if the U.S. economy is to continue to enjoy sustained growth with low inflation and a shrinking trade deficit.

First, the Federal budget deficit must be reduced and it should, and likely will only, be reduced by restraining the growth of Federal spending. A general tax increase that abandons tax reform is not the solution to the budget dilemma. A tax increase would hamper growth and inhibit improvements in productivity. Furthermore, a general tax increase does not eliminate the source of the budget deficit: growth in government spending that far outpaces the growth of the economy in a period of economic expansion. A substantial reduction in the Federal budget deficit will be achieved in 1987 as result of economic growth and a reduction in real Federal outlays. We can and must make similar progress in reducing the Federal budget deficit in 1988 and in later years.

Continued reductions in the Federal budget deficit will make an important contribution to reducing our trade deficit. Our deficit on goods and services trade reflects the fact that, as a nation, we are spending more than we are producing and importing the difference. A substantial portion of this excess of expenditure over income has resulted from large budget deficits in the third and fourth years of an economic expansion. Reducing our external deficit will require that we bring national expenditure in line with national income.

Implementing a growth-oriented reduction of external imbalances also requires that surplus countries shift to

internally-led growth as the United States adjusts. Progess has been made on this score, as evidenced by the supplementary budget measures recently announced by the Japanese government. Stronger domestic demand growth abroad will undoubtedly broaden the market for U.S. exports, but the primary purpose of such policies is not to benefit U.S. exporters, it is to sustain world growth. It is the surplus countries that will suffer from slow growth and rising unemployment if domestic demand abroad fails to strengthen. No matter what these countries do, we need to get on with the business of cutting the United States Federal budget deficit.

Second, protectionism must be resisted. Our trade deficit is not primarily a product of narrow commercial policy actions taken against the United States. While it is important that we continue to strive to open foreign markets for U.S. exports, significant reductions in our trade deficits depend largely on the macroeconomic policies followed by the United States and our trading partners.

Our international cost competitiveness declined during the first half of the 1980s because of the appreciation of the dollar. This appreciation has now been substantially reversed, and the relative cost competitiveness of U.S. producers has been largely restored. For example, in 1986, unit labor costs in manufacturing rose an average 27 percent in our industrial trading partners when measured in dollar terms. Unit labor costs in Japan rose an astounding 42.6 percent in dollar terms. By contrast, unit labor costs in the United States actually

declined.

As a result of this significant improvement in U.S. cost competitiveness, trade-sensitive industries of our trading partners now face a period of adjustment. This adjustment will undoubtedly increase protectionist pressures abroad. It would indeed be tragic if we encourage proteqtionism abroad just as the United States is set to enjoy a period of export-led growth.

The third challenge is to put in place policies that will contribute to a rising standard of living while improving our international competitiveness. This is the objective of the President's competitiveness bill, and it should be the aim of any trade legislation that is passed by Congress. The key to increasing our standard of living is increasing productivity. Increased productivity means that more goods are being produced and consumed by American workers. Increased productivity means that American workers can earn high wages and still produce goods at lower costs than low wage, low productivity countries. In the long run, our growth depends on eliminating burdensome regulations that stifle innovation and the efficient use of our national resources. Instead of adopting a defeatist, protectionist response to our trade deficit, we should focus our energies on this positive approach to enhancing our international competitiveness and raising our standard of living.

Senator SARBANES. Thank you very much, Mr. Sprinkel. I think we will take 10-minute rounds.

Mr. Sprinkel, I want to put a hypothetical question to you first, as they do in these multiple choice questions in the various professional school aptitude tests.

If you were confronted with the following four scenarios of how the economy was functioning, which would you prefer?

An 11 percent unemployment rate, zero inflation; 9 percent unemployment, 2 percent inflation; 6.5 percent unemployment and 4.5 percent inflation; and 3 percent unemployment and 8 percent inflation.

Would you have a preference among those or would you grant them all equal status with respect to the economy?

Mr. SPRINKEL. I would say none of the above, and the reasons——

Senator SARBANES. I understand that, but I just want you to pick one.

Mr. SPRINKEL. May I explain why I don't like the choices? It builds into the choices the so-called Phillips curve which, in my opinion, is not verified in the data. Most of the good work indicates to me that you can get the unemployment rate down while holding the inflation rate down. That is our objective. We haven't perfectly achieved it, but we are moving there and I want to keep moving. I'm not happy with 6.2 percent unemployment, which is what we have today, nor am I happy with an inflation rate that is at least temporarily above 4 percent.

So I think we can make progress on both and we have made progress on the two in combination and I think we can continue to do so.

Senator SARBANES. Without necessarily disagreeing with that, I would still ask which amongst these four scenarios, for how an economy would be functioning, do you think would represent the healthiest situation?

Mr. SPRINKEL. None of them. They are all unhealthy; 11 percent unemployment—no one would choose that.

Senator SARBANES. Would you rather have the current situation than a situation in which we had 11 percent unemployment but no inflation?

Mr. SPRINKEL. Yes, sir, because I think we have a good shot at pulling that inflation number on down and furthermore making additional progress on the unemployment.

Senator SARBANES. And the current situation is about 6.5 unemployment and about 4.5 percent inflation, isn't it?

Mr. SPRINKEL. 6.2 percent, as I measure it, but you could pick 6.3, that's right.

Senator SARBANES. So that scenario is roughly the current situation. You would rather have that than 11 percent unemployment?

Mr. SPRINKEL. Yes, sir.

Senator SARBANES. And you would rather have it than 3 percent unemployment and 8 percent inflation, wouldn't you?

Mr. SPRINKEL. Well, that's a little tougher. I would prefer to have 3 percent unemployment and 3 percent inflation or less, but I doubt we can get down to 3 percent in the present environment,

but I think we can get another percentage point or so below where we are now.

Senator SARBANES. I don't really differ with where you want to go. I only want to try to spear this use of the so-called misery index right at the outset because it equates 1 point on the unemployment rate with 1 point on the inflation rate and that equation just doesn't work. It all depends on what the combination is.

For example, I can give you 11 points on the misery index and do it with 11 percent unemployment and zero inflation, or I can give you 11 points on the misery index with 6.5 percent unemployment and 4.5 percent inflation, and I dare say I don't know that you would find anyone around who would prefer 11 percent unemployment, which would be the worst downturn since the Great Depression.

So I just want to make the point that this so-called misery index is really sort of a bogus indicator. I think we need to look at the unemployment rate and we need to look at the inflation rate and we need to look at other measurements as well in judging the health of the economy. There is no basis in the analysis for simply adding them together. It ends up giving us some totally unacceptable conclusions, if we make this simplistic addition and then form comparisons on that basis.

Let me ask you, in your prepared statement, you make reference to real net export deficit, and I wondered if you could just define that for us?

Mr. SPRINKEL. Yes, sir. It's an attempt to measure physical changes in physical volumes of net exports using the appropriate indices as reported in the GNP report that comes out each quarter, and we try to look then at the annual rate of change and then to convert that annual rate of change to the contribution—in this case positive contribution, but previously negative contribution—that it makes to real GNP growth.

And if you look at changes in physical volume, both on the export and the import side, you find that it's added about 1.6 percent annual rate to GNP growth over the past two quarters and prior to that time, for maybe 3 years, it was dragging growth about 1 percent.

Senator SARBANES. Now what we owe abroad—in other words, the accumulated debt held overseas, is based on the nominal figure, isn't it? That would be your next paragraph, is that correct?

Mr. SPRINKEL. Yes, sir, but——

Senator SARBANES. In other words, under your analysis, we could have an improvement in the real net export deficit and still have a deterioration in the dollar terms?

Mr. SPRINKEL. Yes, sir.

Senator SARBANES. That didn't happen. We had a little bit of a shrinkage, but you're using one analysis that shows an improvement and yet the other one could show a continued deficit, is that correct?

Mr. SPRINKEL. You not only could show continued deficit, but it could show and did show for a while a deterioration in the deficit, and that's primarily due to the so-called "J" curve effect which raises the price of imported products and keeps imports up even though—dollar numbers up—the real dollar has been declining.

Senator SARBANES. Last week the Department of Commerce released figures showing that U.S. foreign debt rose from $112 billion at the end of 1985 to $264 billion at the end of last year.

Since 1981, the United States has gone from being the world's largest creditor nation to being the world's largest debtor nation, with an unprecedented $400 billion decline in our net foreign investment position.

Now even if our trade deficit situation improves—and I'm talking now in nominal terms, in dollar terms—the debt position will continue to worsen until we get the trade deficit back to a positive figure. Is that not correct?

Mr. SPRINKEL. Yes, sir, that's correct, although it's not quite correct to say it's a debt. Part of it is a debt. Part of it is also equity. That is, during this period when we're spending more than we are producing, there's only one way a nation can do that—it's quite analogous to an individual—you can spend more than you earn and produce provided you are willing to liquidate assets and/or borrow, and as a nation, we have done some of each.

So that part of it is debt, part of it is equity, and, of course, dividends need to be paid when earned, but if not earned they don't have to be paid, whereas interest has to be paid.

There is a significant difference, however, even over and about that comment, between our so-called debt—it's actually our net deficit in foreign ownership versus our own ownership of their assets—and that is, those assets and liabilities are denominated in dollars, not in foreign currency, as is true of many of the debtor countries that do have great difficulties.

Finally, I would add that our net deficit position, although going in the wrong direction—and I agree with you on that point—is still quite small either in relation to our income as a nation or in relation to our assets. About 6 percent of total national income is represented by that deficit position and something near 2 percent of our asset position is indicated by that net deficit position.

So I am not disagreeing with you that we have to show a positive—I agree with you that we must show a positive trade account in order to reduce that net deficit position.

Senator SARBANES. Well, my time is up. I will come back in a second round. Just let me put one final question to you.

In discussing how to address the budget deficit, you said "a general tax increase" was not appropriate. What is the definition of a general tax increase or a general tax increase as compared with what other kind of tax increase?

Mr. SPRINKEL. Well, I don't want to imply that a nongeneral tax increase is agreeable, but what I had in mind was that reversing the sharp cuts in marginal tax rates would be highly inappropriate. As you know, we at CEA spent a lot of effort over the past year attempting to estimate the impact on economic growth, not only of the President's proposal but several subsequent versions, including the one at the end, the one the House and the Senate agreed and the President signed the bill, and we believe that the net effect of reducing those marginal tax rates, both on individuals and corporations, is a strong positive for economic growth, that something on the order of 2 percent real growth will occur that otherwise would not have occurred.

Therefore, all I'm arguing in that sentence is let's not kill the goose that's going to lay the golden egg, let's keep those marginal tax rates down and continue as we are doing this year—that is, restraining government spending growth while promoting economic growth.

Senator SARBANES. I take it the use of the word "general" was not inadvertent?

Mr. SPRINKEL. That was on purpose, but as I indicated, I don't want to imply that any other kind of a tax increase other than raising marginal rates is desirable, and the President has been quite specific of late that he is against all tax increases.

Senator SARBANES. Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

I think I agree with Chairman Sarbanes on the worth of the misery index in policymaking. The misery index was concocted during the presidential campaign of 1976 to show the combined ill effects of unemployment and inflation and, if I recall correctly, continued reference to it eventually backfired on the Carter administration and his 1980 candidacy for President. I used the misery index today to help make the point that Americans are far better off today than they were in 1980.

Now it may be that we want to give more weight to the unemployment figure than we do to the inflation figure. I don't know. The misery index may not be good economics, but it looks like food for political economic thinking. I think the unemployment rate and the rate of inflation are clearly important factors that need to be taken into account and could be useful guides in determining the state of our economy at the present time.

Senator SARBANES. Well, I'm just trying to get good economic thinking and good political thinking in harmony together.

Representative WYLIE. If we could do that, we would certainly all be happy. I would add that I'm not suggesting that there are tradeoffs, as the Phillips curve suggests—and that's the point you were making—but on the other hand, we do need to have some indication like that as to the state of the economy.

Mr. Sprinkel, the value of the U.S. dollar has changed tremendously in the 1980's. A few years ago, many analysts thought it was too high and now many think it's too low. It seems to me that high or low is in the eye of the beholder.

In your opinion, what is the "appropriate" value of the dollar? Is there a consensus on the desired level for the dollar? And I know that you're not likely to answer that question.

Mr. SPRINKEL. Yes, sir, you're correct. There are two people in the President's administration authorized to answer that question. One is the President. The other is the Secretary of Treasury and I am neither.

Representative WYLIE. I asked that question of the Secretary of the Treasury and he said he wasn't authorized to answer that question.

Mr. SPRINKEL. Well, he's authorized, but I have urged him not to exercise that option too often. The reason being that any kind of statement made by a senior government official, unfortunately, sometimes adversely or otherwise impacts the markets. And we don't think it's appropriate for us to cause those kinds of problems.

Representative WYLIE. I understood and I was laying the groundwork for the next question.

Can we expect or could we possibly have an inflation from a further substantial depreciation of the relative exchange rate of the dollar that could not be curbed by the traditional anti-inflationary tools of monetary and fiscal policy?

Mr. SPRINKEL. I doubt that. It seems to me the proper way, at least in my mind, look at the inflation result from a currency depreciation is sort of a one-shot effect that gradually comes back to no effect; that is, if you increase the cost of imported goods and part of that goes into our general price level, while that adjustment is occurring, it will show up as a higher inflation rate. Now eventually, unless you expect the dollar to continue to go on down in our case, once it levels out, as it has of late, you would expect that it would not further increase the inflation rate so that the inflation rate would come back to where it was before.

Whereas, the general monetary stance of the Nation I think almost all economists would argue that it has something to do with not the supply-side effect that I'm mentioning, either exchange rates or oil, but it has something to do with the overall level of inflation, although there is some disagreement as to how much effect it may have.

So I think that if we were to have, as we are now seeing, a rise in the inflation rate partly induced by the weak dollar, we anticipate that that will phase out and it certainly can be prevented in the future with the proper monetary policy.

Representative WYLIE. Thank you. In your prepared statement, you state that under an appropriate monetary policy this should not happen—that the inflationary process begins to affect domestic costs, wage rates, and profit margins. This should not happen provided that workers and firms continue to recognize the nature of the international competitive situation. I think you were trying to make a point there and I wonder if you would expand on that.

Mr. SPRINKEL. Well, one of the important points that was made in that particular sentence was that clearly the significant improvement in productivity and the significant improvement in unit labor costs in the United States—and those measures relate to manufacturing industries—came about to a considerable extent as a result of very tough competitive environment especially for exports and for imports that are competing with our own producers. That is, they have succeeded in improving the way we do business by improving productivity. They have done it at relatively small increases in nominal wage increase costs and that in this kind of an environment, if we suddenly no longer have a competitive problem, you couldn't count on that as keeping productivity up and wage rates down. Especially you couldn't count on it if you began to get an inflation that's induced by excessive money growth.

What I was hoping to say was that we don't want an inflation induced by excessive money growth and that means less growth probably then we've had over the past 2 years.

Representative WYLIE. You mentioned the President's competitive package and we did pass the trade bill in the House. I'm not sure where it is over in the Senate. I guess they are continuing

their work on it. Are we winning the competitiveness challenge now facing us?

Mr. SPRINKEL. I think so, and the real risk is that just as we're winning we will end up losing by moving down the protectionist road. We are winning in several ways. We are winning by more productivity improvement than we have seen here in a long time, but also more than we are seeing abroad. We are winning by cost constraints—that is, dollar unit labor costs have been actually declining, not rising; and, of course, we are winning on this front as a result of the weaker dollar which has been underway since February 1985.

So if you look at the three forces combined, it's very clear that our manufacturing industries now have the capacity to win the competitiveness battle. Is it going to happen in all industries and companies overnight? Certainly not. It took a couple of years or so to get into serious weakness on their ability to compete abroad, and even though the numbers show great improvement, it takes a while for it to show up in company profits, company exports. But I am getting more and more good examples around the country that it is beginning to show up on the books of American producers and therefore I am quite optimistic that we are winning. And just as we are ready to pick up the marbles in this game, I would be distraught if our policies became so protectionist that it induced reciprocal action abroad and we would all lose.

Representative WYLIE. That's encouraging news certainly. And this is an oversimplification, but the real solution to the problem of the trade balance is to increase our exports—that's what you're saying—and not to limit imports, and that's the message that came through loud and clear and I agree with you.

Thank you very much, Mr. Chairman.

Senator SARBANES. Congressman McMillan.

Representative MCMILLAN. Thank you, Mr. Chairman.

I don't want to dwell too much on the misery index. I think it's a little misleading myself. But compared to 1980, I think the significant thing—and this is what you basically said—is we've made improvement in the unemployment rate; we have created somewhat in the neighborhood of 13 million jobs in that time interval, one of the highest rates of new job creation on record if I'm not mistaken; and we have brought the inflation rate down from double digit levels to certainly the one percentage you pointed out late last year was energy-related and probably the real rate is somewhere in the 3 percent moderately plus, which in historical terms is—I don't want to say acceptable, but is a marginally good level in the rate of inflation. So I think the general trend is good and, hopefully, we can continue it.

You indicated you thought that a real growth rate in GNP in the latter 1987–88 period was in prospect on an order of 3 percent and there are some comments that indicate that people find something less than 3 percent not very exciting.

Could you briefly put that 3 percent in some kind of perspective in either historical terms in our own experience or in relation to other nations around the world that we sometimes perceive as enjoying an above-average growth rate?

Mr. SPRINKEL. Well, the 3 percent rate of growth is very close to the very long-term average rate of growth of the U.S. economy. We sort of use that as a base mark.

When you are moving from periods of excessive unemployment, as we have been in recent years, down toward whatever full employment may be, clearly the economy can grow somewhat more rapidly than that 3 percent base line, and it's our expectation that in the period immediately ahead we have a very good chance of doing that, primarily because the major drag on growth—that is, a worsening trade balance—is going to be a positive and we are going to see some moderate improvement in both consumption and investment outlays.

Now if you look abroad, with very few exceptions, almost all nations would be delighted if they could grow 3 percent. I think we are going to beat that in the United States. The U.K. is probably doing a little better than that presently. The Japanese, maybe. But everyone else is down around 2 percent or less.

Consequently, anything above 3 percent ranks very well compared to immediate prospects in most of the developed world. We can probably do a little better than 3 percent without running risks of sharp acceleration in inflation, and I think we will.

Part of our difficulty in being too precise about these numbers is that despite the best efforts of Commerce Department employees and others to measure productivity improvement, we are probably not doing a very good job.

I think we are doing the best job on manufacturing, those numbers that I cited in my testimony, because it's easier to count. And that's where most of the exports occur. But when you back up into the service sector of the economy, which is a very important part of the total, it's extremely difficult to decide whether it's productivity improvement or a price increase and we show very slow productivity improvement, almost nonexistent, in many of the service industries. And if we had a proper handle on that, my guess is that our base would be somewhat higher than the 3 percent I referred to and that maybe we ought to be growing at 3.5 percent on average if we had a proper way and a better way of measuring service productivity and growth.

I don't have any recommendations as to how to do it. It's a very difficult intellectual exercise and there's still a lot of work being done trying to improve it.

One industry that I know something about, banking and finance, I believe I'm correct that it shows zero improvement in productivity in that industry over the last decade and so, and I know bettter than that. All of the things that have happened to improve the services available to the American public clearly represents a significant improvement in productivity and yet it doesn't show up in the GNP growth numbers.

So I wish we had better numbers and I know we're trying to get them, but I'm not too confident we have them yet.

Representative MCMILLAN. That's an interesting question that's arisen in our monthly review with the Labor Department and we sort of jokingly ask the question, how do you measure the productivity of liability losses? I mean it's extremely difficult. I wish we did have an answer.

Getting back to the relationship of growth of GNP and the past recent history and prospects for the future, over that same roughly 4-year period in which I think it would be accurate to say we have enjoyed a real growth rate of some 4 percent over the past 48 months——

Mr. SPRINKEL. That's correct.

Representative MCMILLAN. And the trade deficit during that period of time went from insignificant levels up to the $160 billion plus, so at the same time that we've been able to bring inflation down, reduce the unemployment rate, maintain a growth rate on an order of 4 percent, we have absorbed the effects of a net trade deficit of $160 billion plus a year, which is equivalent to 4 percent of GNP. Is that not correct?

Mr. SPRINKEL. Yes, sir, that's correct.

Representative MCMILLAN. Could you translate that in terms of the growth in the economy and job creation that it's taken to overcome that difficulty, which I think is a measure of positive strength in the economy even if we dislike the trade deficit?

Mr. SPRINKEL. It's hard to translate in a useful way. If I had more time perhaps I could. In the manufacturing area, we haven't actually had a decline in manufacturing output. As a percentage of GNP, it's held fairly stable, but we've had a very significant decline in the employment in those industries and, of course, it's been more than made up by significant increases in jobs in the nonmanufacturing area such that, as you indicated, we've had about 13.6 million new jobs net, counting the ones that were lost in the manufacturing area due to weakness in our trade accounts. And now it's going the other way. We're going to be gaining jobs as we have been of late in the manufacturing sectors as our net export situation improves.

Representative MCMILLAN. One final question again relating to GNP growth and relating it back to the dilemma that the Congress finds itself in and that is wrestling with the issue of spending restraint; and hopefully tax rate increase restraint as well in terms of coping with the budget deficit.

The 3 percent real growth rate that you've indicated is a possibility would, in your judgment, generate how much additional revenue without any modifications of the current tax structure on an annual basis?

Mr. SPRINKEL. Well, you have to look at both the real and the nominal—that is, the inflation plus the real—to get a feel as to how much revenues would increase. And if we got a nominal increase of 7 or 8 percent in GNP, off the top of my hat, I would expect something on the order of $40 to $50 billion. But I would be glad to check that number to give you a more precise number. Treasury makes those official estimates and they certainly aren't made off the top of my head, but I'll try to give you a response.

Could I add one footnote relative to the misery index? It's not my favorite index either, but it was concocted by one of my favorite friends, Arthur Okun, who was Chairman of the Council of Economic Advisers in a Democratic administration. So I don't want to put that index down too hard. It does have a useful role, even though it isn't a perfect index.

Representative McMILLAN. I was going to make one final remark to the revenue projections with no tax increase. I think it's an extremely critical figure in terms of the actions that Congress is expected to take because it tells us what we could expect reasonably given a certain base growth economic assumption within the existing revenue mix in terms of possible deficit reductions through growth in the economy. That's an extremely critical number for us to come up with. I know those assumptions are generally made, but I would be interested if you would have at some point some further comment on that.

Mr. SPRINKEL. Yes, sir. I'll send you some information on it.

Representative McMILLAN. Thank you.

Senator SARBANES. I'm going to have to go vote, but before I turn it over to Congressman Solarz, I want to put one other question to you, Mr. Sprinkel.

Having battered around the misery index a little bit here this morning, I want to batter around another use of terminology.

Let me put this question to you first by way of preface. Would you rather be strong or weak?

Mr. SPRINKEL. Strong in what characteristic?

Senator SARBANES. Obviously, you would rather be strong. I don't know of anyone who is going to opt for being weak.

Is the dollar value that we have now, which is much, much "weaker" than the dollar value we had 2 or 3 years ago, a better dollar for us in terms of our economic purposes?

Mr. SPRINKEL. I would have to say, net balance, yes; but there are some offsetting factors, as I'm sure you are well aware.

One of the major overriding problems we've had recently in the last 2 or 3 years, which had been I think largely responsible for the pressures toward protectionism which I consider an unmitigated evil, has been the strong dollar. Therefore, as we pull the dollar down or the market pulls it down, it significantly improves our competitiveness, thereby improving our trade balance and, I hope, thereby reducing protectionist pressures in the United States.

However, let me add, as I'm sure you are also well aware, that as our dollar comes down, it means that we have to pay more for imported goods, that it is a limiting factor on U.S. standard of living from the standpoint of our ability to acquire goods and services from aboard and, of course, that's a negative.

Senator SARBANES. But it was an overvalued dollar, wasn't it, under any reasonable analysis of the underlying economic factors?

Mr. SPRINKEL. When you look back and you can say in hindsight it was certainly overvalued with respect to our ability to get our growing trade deficit under control.

Senator SARBANES. Wouldn't it make more sense when we discuss this issue to talk about overvalued or undervalued or appropriately valued rather than strong and weak?

Mr. SPRINKEL. I don't know how to do that.

Senator SARBANES. Why, then, did Secretary Baker set out to give us a weak dollar if he could do it? Why didn't he keep a strong dollar?

Mr. SPRINKEL. I believe that the dollar peaked out in February 1985 and dropped quite substantially and consistently up to and

subsequent to the meeting where the statement was made by finance ministers which I believe was September.

Senator SARBANES. Was that a good or bad development?

Mr. SPRINKEL. The decline in the dollar?

Senator SARBANES. Yes, at that point.

Mr. SPRINKEL. I just mentioned earlier that, net balance, considering the pluses and the minuses, I consider it highly desirable that forces are——

Senator SARBANES. So you thought it was highly desirable to get a weaker dollar at that time at least?

Mr. SPRINKEL. And in that set of circumstances.

Senator SARBANES. Well, that makes my point. I just think we ought to stop using these words "strong" and "weak" with respect to the dollar. Obviously, because of our general usage of those terms, "strong" and "weak" carry a certain presumption or impression. We should talk about the dollar in different terms so that we can actually analyze what the situation is.

Mr. SPRINKEL. But it's very difficult, sir, to make an honest statement about overvalued and undervalued. You have an enormous market out there. Each and every day, well over a $100 billion a day goes through that market and clears—maybe $160 or $170 billion is the latest estimate I've seen—and to say that I know better than that market knows whether the dollar is overvalued or undervalued requires a certain amount of knowledge and arrogance that I am unwilling to indicate that I have. If I had it, I would. But many people feel very confident in saying it's over and under. I don't. I feel it's strong or weak.

Senator SARBANES. Well, all right, but it might get you out of a situation of having endorsed getting a weaker dollar, which you just did this morning. I mean, you don't like to be in that position either, do you? You don't like to move to weakness obviously.

Mr. SPRINKEL. We're talking about a particular date, September 1985, not June 1987.

Senator SARBANES. Congressman Solarz.

Representative SOLARZ. Thank you very much, Mr. Chairman.

Mr. Sprinkel, it's good to see you again, sir.

Mr. SPRINKEL. Thank you.

Representative SOLARZ. Could you please explain for me the relationship between the budget deficit and the trade deficit and how both together impact on the prospects for economic growth?

Mr. SPRINKEL. Yes, sir. Our economy, of course, generates both savings and investment both in the private sector and in the public sector, and in modern times we have, in essence, generated more investments of various kinds than we have savings.

Consumers have saved a little bit but not much, especially of late. We tend to be a high consumption nation for reasons that perhaps most of us don't fully understand. We know that on the business side of our economy they tend to generate more investments than savings.

Then we have State governments who in more recent years have been net savers. They have been running surpluses, not deficits. That's not true for every individual State but it's true in aggregate.

For the Federal Government, we have for several years now, in fact many, run some kind of a deficit, but for several we have run very sizable deficits.

Now if you add together the savings and investment that are occurring and have been occurring, we run into a savings deficit. We are spending more than we are producing. The way we finance that activity is to, in essence, acquire savings from abroad.

The Federal deficit is one of the important components of that savings-investment balance. It's not the only one. It's one of at least four broad categories. It's not unusual to have a Federal deficit—in fact, it's quite usual to have a Federal deficit in and around recessions, during a recession, in the early phase of a recovery.

What is rather unusual is to continue into the fourth and into the fifth year of an economic expansion with a very sizable Federal deficit, and I have argued in the Economic Report, in speeches and here this morning that it's highly desirable that we pull that deficit down in a way that does not slow economic growth.

Representative SOLARZ. My question was, what is the impact of the budget deficit on the trade deficit?

Mr. SPRINKEL. That's exactly the point. Maybe I didn't make it too clearly. If we are spending more than we are producing, this means we are spending part of it on goods abroad which means we are importing more than we are exporting. So that the larger the net savings deficit in the United States, the larger the net trade deficit.

To the extent that the Federal budget deficit contributes to that savings deficit—and it's a rather important contributor—the larger the Federal deficit, other things being the same, the larger the trade deficit.

Conversely, coming the other way, it's extremely important to pull the fiscal deficit down.

Representative SOLARZ. Well, how much of the trade deficit would you attribute to the budget deficit?

Mr. SPRINKEL. Well, I don't like the dollar-for-dollar comparisons. The numbers are not too different. But I don't want to be placed in the position of saying that all of our trade deficit is due exclusively to the fiscal deficit, but the numbers are reasonably close. We're talking about, depending on how you measure it, $140 or $150 billion trade deficit this year, and we're going to have a fiscal year this fiscal year of maybe $170 billion plus or minus a little. So the numbers aren't off very far with the fiscal deficit somewhat larger than the trade deficit. But I don't want to imply that that trade deficit is exclusively due to the Federal deficit because it isn't. It's the interface of all of the savings and investment decisions and one of them is in the Federal budget.

Representative SOLARZ. So if we somehow or other were able to make dramatic progress in phasing out the budget deficit, how much of a reduction would that bring about in the trade deficit?

Mr. SPRINKEL. Well, I think it depends on how you do it. If you do it in a way that severely limits economic growth, you're going to cut down savings elsewhere in the economy that would partly offset the improvements you make on the Federal side.

One extreme case would be to say we're going to do it overnight; we're going to go from a $170 billion deficit to zero next year. No

one is seriously proposing that, but that would be a good case where almost certainly, if we tried it through spending restraint or tax increase, you run a serious threat of inducing an economic recession which would cause a lot of other damages. But short of that, substantial tax increases that take funds away from the private sector would tend to reduce savings flows and, therefore, I would like to see it happen in a way where we can have good sustained growth in the private sector and generating additional revenues and, at the same time, restraining growth in spending.

Representative SOLARZ. What figure do you personally consider to be the equivalent of full employment? What unemployment rate is consistent with full employment?

Mr. SPRINKEL. Well, I'm not certain, and it depends a lot on what the Congress does in several areas. But let me try.

No one believes, and I certainly do not believe, that we are at full employment today. I think we can do better. We have continuously done better but there's room ahead. Even in our 5-year projections out we have been talking about at least pulling the unemployment rate down somewhere in the 5 or 5.5 percent range for the total economy. So another percentage point ought to easily be doable.

There are a series of proposals here in the Congress, however, which if passed, in my opinion, would raise that so-called full-employment rate—that is, the rate which could be achieved without inducing massive inflation—much higher, such as substantial increases in the minimum wage, such as substantial mandated benefits not showing up in the budget per se but showing up in the budget of businesses. If we were to change those factors adversely, we would severely depress and injure our job-creating machinery that's had such a marvelous record and we would be joining the model of these proposals—that is, Western Europe—where they have not been creating jobs for well over a decade.

Representative SOLARZ. I gather you don't care to name a percentage then, whether it's 3 percent or 4 percent?

Mr. SPRINKEL. I said I think 5 is safe. When you come below that, I feel less and less confident. We used to believe 4.

Respesentative SOLARZ. Well, Japan has, as I understand it, 2 to 3 percent unemployment, roughly comparable inflation. If 2 to 3 percent unemployment in Japan is compatible with low inflation, why shouldn't that be the case here?

Mr. SPRINKEL. Well, they have a different organization. I can cite Western Europe as having approximately 10 percent, which is very unfortunate. Japan has created new jobs, not nearly as rapidly either absolutely or percentage wise as we have, but I am rather doubtful that we could pull the unemployment rate that low without substantial further moves to improve the flexibility of our labor force, and I don't see that happening.

Representative SOLARZ. Well, perhaps you could submit an analysis as to why the Japanese have been able to do it and why you think we couldn't.

Mr. SPRINKEL. I would be glad to take a look at that.

Representative SOLARZ. There was an article a week or so ago in the New York Times by Mr. Jim Hightower of Texas who said

something that struck me as rather remarkable if it's true. I'd like to mention it here and ask you to comment.

He said that 15 years ago the richest 1 percent of American families held 27 percent of the Nation's wealth. Today, they are approaching and may soon surpass the 36 percent peak share attained in 1929. Is that true?

Mr. SPRINKEL. I don't know but I can check it. I assume it's true. Otherwise, I don't think he would publish it.

Representative SOLARZ. Well, I was down in Haiti a few months ago and there, I was told, that 2 percent of the population controlled 47 percent of the wealth, which if you look at Haiti, it's believable. It's probably the most inequitable and unequal income distribution in the world.

But I didn't have the impression that we were approaching Haiti, a country with this kind of gross disparity in income. I would have thought you might be able to either confirm or refute this.

Mr. SPRINKEL. I cannot, but I will check the data. As you are well aware, throughout most of the post-World War II period, regardless of whether you had Democratic or Republican administrations, there has been very little change in income distribution throughout that period. I have read recently that there was a slight tilt of late, but I will check those numbers by Mr. Hightower.

Representative SOLARZ. Well, I would appreciate it if you could.

Just one final question on this round. You spoke about the depreciation of the dollar, but could you tell us why the dollar has remained constant or has actually appreciated vis-a-vis the currencies that account for roughly 50 percent of our trade deficit? The dollar has depreciated vis-a-vis Japan, West Germany, Italy, France, and the United Kingdom. But with respect to countries that constitute about half of the trade deficit it hasn't depreciated and in a number of instances it has gone up.

How do you account for that?

Mr. SPRINKEL. Well, part of it—take the so-called newly industrialized countries—is caused by the fact that they overtly tie their currency to the dollar and as the dollar moves they move with it. Now there has been a little bit of change. I don't want to argue that they haven't moved a little. South Korea, for example, has moved up a little. Taiwan has moved up a little. But essentially they have tied their currency to the dollar and when it's a small currency they can do that.

Whether it's desirable, we think it's not so desirable in fact, that they should be appreciating and reducing the trade balance. Canada tends to be very closely related to the U.S. dollar and it's gone up and down. In the Latin American countries which used to be a very important market for our products, the dollar has not depreciated vis-a-vis those countries in real terms either, and part of that is related to the international debt problem there.

It's primarily with respect to Western Europe and Japan that the dollar has depreciated significantly.

Representative SOLARZ [presiding]. We have another panel of witnesses, but before we get to them I think the members may want a second round. Chairman Sarbanes asked me to substitute for him while he's voting on the floor.

Congressman Wylie.

Representative WYLIE. Thank you. I just have one observation and I won't take very much time on this. On the issue of the distribution or redistribution of wealth, as a starting point to answer for the record here, you might want to look at a 1986 Joint Economic Committee publication entitled "Poverty, Income Distribution, the Family and Public Policy," which was prepared at our suggestion by our staff of the minority members. It indicates that the observation which Mr. Hightower made in his op-ed article is just patently untrue, that the distribution of wealth in the United States today has improved as a matter of fact.

Pensions are a source of wealth which was unaccounted for in the study to which Mr. Hightower refers. There is now $1.3 trillion in pension funds, or about one-sixth of the total value of wealth. That is a significant amount and when you add that into the overall total, there has been a considerable improvement in wealth distribution among Americans over the past few years.

Thank you.

Representative SOLARZ. Congressman McMillan.

Representative MCMILLAN. Let me just go back a little bit, and we may want to explore this further with the other witnesses, on the issue of U.S.-foreign indebtedness. We speak about it as if it were something to be avoided at all costs. Certainly excessive debt is to be avoided if possible.

But isn't the fact that U.S. borrowing has increased inevitably as a result of a persistent trade deficit on the one hand, but on the other hand because the United States is an attractive investment economy for most of the nations of the world with excess capital and in 1986 amounted to on a net basis to approximately $100 billion of incremental investment in this country over and above the trade deficit itself which has to be financed.

Does that also measure foreign equity investment in this country?

Mr. SPRINKEL. Yes, sir, it does.

Representative MCMILLAN. So it's a transfer of payment regardless of in what form?

Mr. SPRINKEL. Yes, sir.

Representative MCMILLAN. Probably the development of the United States historically, if you go back, was dependent heavily upon European capital over time. So it can be interpreted as a sign of health as long as the basic economy in the United States is healthy and it's trending in the right direction. Temporary increases in foreign borrowing aren't necessarily bad. Now if this persisted in a backsliding economy, it would perhaps be a different kettle of fish.

Does the increase in foreign debt in the past 24 months alarm you?

Mr. SPRINKEL. It would if I thought it was going to get larger and larger and larger. That is, if the trade deficit were not improving.

The fact is the trade deficit is improving, has been improving now for many months, has good prospects of improving and, as pointed out by Senator Sarbanes, as long as there's any trade deficit you will add some to the net indebtedness. But the net additions will be smaller and smaller. It's indeed true, sir, that up until World War I and through World War I, we were a net debtor vis-a-

vis the rest of the world. I'm not sure that data were actually released then, but when we look back we can say that. And then from World War I up until a couple of years ago, as measured, it moved the other way. And now, because of the trade deficit, we have moved toward net debtor position, although it's not all debt. It's partly equity.

There is some problem with the numbers and therefore we can't be too confident about the level. I think we can be very confident about the direction of change, that it's getting worse—at least it was getting worse at an increasing rate and it will continue to rise over the next few years until we get our trade deficit improved.

That money, incidentally, is coming here voluntarily. We can't get out there and lasso it. It comes in here on their decision, not ours, and consequently it does reflect some confidence in the prospects of the U.S. economy. It's not as if the trade account always drives it. It can be the investment account that drives it. The numbers of dollars going through the exchanges are much more closely related to the investment accounts presently than they are to the trade accounts, like 10 to 1, something like that.

Representative McMillan. So it's not so much the fact that it exists; it's the character and makeup of it that really makes a difference. If we had an absolute zero trade balance and we still had an incremental investment in this country of $100 billion a year, which is currently what it is, over and above the trade deficit, if we had no Federal budget deficit and that was flowing into the economy it's a very positive thing.

On the other hand, if we're running a domestic budget deficit and the reason for that incremental borrowing is to finance the U.S. budget defict—and certainly part of that $100 billion is that—then that's the kind of problem we have to be concerned about it seems to me.

Mr. Sprinkel. That, plus as we as a nation commit ourselves to pay more abroad then they are paying us. Incidentally, it's still coming our way, despite the fact it shows we're in net deficit, we are still—the last numbers I saw—showed $27 billion more interest and dividend payments coming to us than to them. But that will change if this trend is not reversed.

And to the extent we start paying more abroad than they are paying us, which hasn't happened yet, that will limit our ability to improve the standard of living of the U.S. citizens. So it's not an irrelevant factor, but it's not all bad either for the reasons that you have cited.

Representative McMillan. Thank you.

Representative Solarz. Mr. Sprinkel, you spoke about this remarkable period of continuing economic growth we've had. I think you said it was the longest sustained period of economic growth in a very long period of time.

When do you expect the next recession?

Mr. Sprinkel. I was very interested in a statement made by Senator Sarbanes in his observations talking about the 6 months ahead, and the reason it caught my attention is that economic forecasting tools, in my opinion, are reasonably good 6 to 9 months out. After that, you may as well flip a coin. And I say this after having been in this business most of my life.

I see nothing presently—and that means for the next 6 months—that's going to bring on a recession. I do not believe that expansions die of old age, as some do. I think they die of inappropriate economic policies and we are doing our best to avoid them and I'm sure the Congress is. But I don't want to assure them that there isn't going to be some trouble next year because I can't see that far ahead.

Representative SOLARZ. I assume you are not taking the position that we have suspended the laws of economics?

Mr. SPRINKEL. No, sir.

Representative SOLARZ. That we have invented the equivalent of a perpetual motion machine?

Mr. SPRINKEL. No, sir. I just don't want this recession on our watch.

Representative SOLARZ. But I assume you think at some point it will happen?

Mr. SPRINKEL. Yes, sir.

Representative SOLARZ. And finally, in this article by Mr. Hightower, he also observes that nearly half of the new jobs created from 1979 to 1985 pay less than a poverty level income, $180 a week. Is there any truth to that?

Mr. SPRINKEL. No, sir, there is not. That particular aspect I have looked into very carefully and it turns out that during this period of major increases in jobs over the last 4-plus years, 62 percent of the new jobs created were in the highest paying professions; 12 percent were in the low-paying jobs. And this job machine that we have witnessed has not only increased total jobs in a substantial way, but most of them are in the higher paying, not the lower paying, categories.

Representative SOLARZ. Well, let me thank you very much on behalf of Chairman Sarbanes.

Mr. SPRINKEL. I appreciate your asking that question, sir.

Representative SOLARZ. Let me thank you on behalf of Chairman Sarbanes and the committee. We appreciate your willingness to be with us today.

The committee will now hear from a panel of witnesses, Allen Sinai, the chief economist for Shearson Lehman Bros; and Donald Ratajczak, who is with the Economic Forecasting Center of Georgia State University.

Mr. Sinai, your name seems to be listed here first. Why don't you proceed. Then we will hear from Mr. Ratajczak.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST AND MANAGING DIRECTOR, SHEARSON LEHMAN BROS., INC.

Mr. SINAI. Thank you very much.

At midyear 1987, the United States and world economies are continuing to expand, albeit in a hesitating manner and with growing risks to sustained expansion. Indeed, the challenge to Washington, Bonn, and Tokyo, in an increasingly intertwined and interrelated global economy, is to devise and coordinate policies that can sustain noninflationary growth through the end of the decade.

For our economy, economic growth is now being led by improved foreign trade, a modest industrial sector recovery, an end to the de-

clines in the beleaguered mining and agricultural sectors, and a rebuilding of inventories. This is a healthy development, for just 1 year ago these areas were in recession or depression. Consumption spending has been weak, especially for autos, but is holding up well in services. Business capital spending, except for computers and office machinery, has declined sharply in reaction to the Tax Reform Act of 1986. Housing activity, both starts and sales, is softening in response to higher mortgage rates, a pattern to be expected at this stage of the business expansion.

For the first half of this year, assuming a 1.3 percent increase in real GNP during the second quarter, overall growth would average about 3 percent. That's about the expectation of the Congressional Budget Office, our own expectation coming into this year, at the upper boundary of the central tendency of Federal Reserve expectations, and somewhat below the forecast of the administration for 1987.

As had been expected by most, a turn in real net exports and improved production in the industrial sector have provided the upward thrust to growth. Exports, orders, production, employment and inventories all have been stronger. An expected approximately $28 billion swing for real net exports and $47 billion rise of inventories over the first half account for all of the increase in real GNP this year.

Inflation in the United States is considerably worse, however, rising so far at about 4 percent to 6 percent annualized rates, regardless of how measured. Precious metals, oil and commodity prices all are substantially higher as well. Expectations of inflation were generally 3 percent to 4 percent coming into the year.

The worst inflation so far principally represents the direct and indirect effects of a lower dollar and higher oil and energy prices. About a 25 percent decline in the dollar against a trade-weighted average of foreign currencies since September 1985 is having numerous effects on inflation. A rise in crude oil prices from $14 a barrel last November to about $20 a barrel also has been a major source of the higher inflation, although not unrelated to the decline in the dollar.

The third source is good-sized increases in services prices which are now a much bigger part of our economy.

The higher inflation this year and a shift of funds away from U.S. fixed income markets by foreign investors have caused significant rises for longer term interest rates, which are up 1 percentage point and more since the end of last year. With inflation now on a higher plateau, so are long-term interest rates. Typically, once a reacceleration of inflation begins, interest rates trend irregularly higher. Short-term interest rates are about one-half percentage point higher than at the end of the year, reflecting central bank defense of a weak dollar and the higher inflation. Expectations generally had been that interest rates would not rise over the first half. In fact, the consensus had been for rather significant declines in interest rates over the first half.

Sustained growth, a better balance in the components of expenditures, improving foreign trade, a stronger industrial sector, and good profits results represent the good news on the U.S. economy this year. Continuing large and seemingly intractable Federal

budget deficits, only a slow turn in the trade deficit, still downside risks to the dollar, worsened inflation, and higher interest rates are the negatives and the risks facing the economy.

The possibility that inflation could stay high and go higher and the potential for increased interest rates has to us increased our assessment on the risk of a recession in the next 6 to 15 months to 1 in 4 from an assessment on 1 in 10 at the beginning of the year. We made this change about 3½ months ago, from 1 to 10 to 1 to 4, and we've had no change since. But whether the expansion lasts 6 more months or through the end of the decade, I think, depends very much on the policy choices of the major economic powers, no longer just the United States but now also Japan and Germany, in order to deal with some very substantial external and internal balances—the deficit and trade imbalances that face them. Policy coordination between countries is more necessary now than ever to keep worldwide expansion going.

Most troubling and risky is the continued lack of progress in dealing with a budget impasse that threatens to leave the Federal budget deficit by our estimates at levels of $180 billion to $200 billion over the next few years. These deficits, the result of the large tax cuts of the 1980's, slower than potential economic growth, and large increases in government spending, if sustained, will leave the United States with two few fiscal degrees of freedom if a recession should arise. Still high trade and current account deficits, although improving gradually, also represent a risk, principally to the dollar, inflation and interest rates; thus, also to the economy, although not an immediate threat to an expansion which actually looks more well entrenched now. The "twin deficits"—budget and trade—and associated debt, higher inflation, and possibly higher interest rates probably have started the clock ticking on the next recession, most likely to occur in 1989 or 1990.

Let me very briefly deal with a couple of highlights of the economy at midyear in the process and the questions asked by Chairman Sarbanes in his letter.

I think the theme so far this year and for the next year in the economy is reasonably good growth with better balance. The areas of activity that previously were weakest are now stronger; those categories of spending that previously were strongest are weaker. In particular, net exports after adjustment for inflation have responded to a lower dollar, rising almost $30 billion between the third quarter of 1986 and the first quarter of 1987, and we expect a further improvement of about $28 billion over the remainder of the year. Exports, in real terms, are up about $37 billion since mid-1986, pretty much across-the-board, stimulating the U.S. industrial sector to produce more, both for inventories and sales, as well as increasing the flow of orders and firming up employment. Between mid-1984 and mid-1986, declines in real net exports subtracted about 1½ percentage points a year in real growth from our economy. The other beleaguered sectors, mining and agricultural, also are past the worst. They are not expanding much but they are not declining any more. When you have manufacturing doing better and sectors that previously were in a depression at least having come out of that, you remove a lot of drag on the U.S. economy and

assure that the growth can continue, especially given the strong services area of our economy.

For the rest of this year and next year, we would expect continuing improvement in real net exports and an expansion in the industrial sector to provide the major thrust to growth. Consumer spending, which has been very weak, mainly in auto spending so far, is likely to pick up but nowhere near the robust expansion of 1985 and the first part of 1986. Business capital spending is likely to remain soft for much of this year, but next year pick up some as the industrial sector continues to expand.

Overall, we expect a 3.1 percent pace of growth for 1987, fourth quarter to fourth quarter. That represents essentially no change from our forecast as we came into the year. And, 3 percent plus on growth next year as well.

The sustained growth depends on continuing improvement in trade, the industrial sector keeping on in its expansion, and consumer spending picking up. It also depends on no further major decline in the dollar and on inflation staying in the 4 to 5 percent range, and no rises in interest rates beyond a percentage point or so.

The big change so far this year, and reason for wondering about how long the expansion will last over a longer time stream, has been the sharply higher inflation and higher interest rates that have risen. The weaker dollar, higher oil and energy prices, I would say, a more weak dollar than had been expected, and they are related, and worse than expected inflation—all of these are related—have combined to send interest higher, particularly in order to establish returns that are satisfactory to foreign investors. Dollar weakness, higher inflation, and higher interest rates have occurred almost simultaneously as the major surprise of this year.

The major inflation indices all have shown substantial rises so far this year. We have not had a classic demand-pull inflation. The rises are due to the lower dollar, higher energy prices, and higher services prices. The only demand-pull inflation that seems to be present is in services. Unit labor costs, especially in manufacturing, have been rising slowly or occasionally declining.

This much worse inflation so far this year is the key issue for how the business expansion winds down the next 6 and 12, 18 and 24 months. The history of inflation once it has begun is that it is not a spike-like event. It is not a one-shot affair, no matter what the initial source, which passes and recedes in an economy that is continuing to expand. Once initiated, higher inflation from any source typically reverberates through the economy, impacting on decisions and expectations of other prices of goods and services, and into wages and eventually unit labor costs.

We certainly are not headed into a 1970's-like inflation experience. World economies are too slack. Wage increases are too modest. But more progrowth, macroeconomic policies overseas, more stress on higher growth here, and the already entrenched start to inflation makes this particular area of performance in the economy a very risky one for the future of the expansion.

I think no one would object to 3 percent inflation or think that is harmful to the economy; 4 to 5 percent, for my own case, is too high. But these days, 4 to 5 percent doesn't seem to be disturbing

too many policymakers. Certainly 5 percent or more most would consider to be unacceptable.

Another big change since the beginning of the year has been a substantial improvement in the unemployment rate. Since last September, the unemployment rate is down 0.7 of a percentage point. We are now running at 6.3 percent, which is very good for the civilian unemployment rate, unusual in that it's occurred with growth in our economy of only 2 to 2.5 percent. Another rule from Arthur Okun, called "Okun's Law," says that you get a 1 percentage point decline in the unemployment rate over time if actual real economic growth exceeds potential growth by 3 percentage points. Well, actual growth has been 2 to 2.5 percent and so this unusual decline in the unemployment is puzzling. It's a pleasant surprise. Job growth has been very substantial.

What is suggested to me is that the potential growth of the economy is not so high as most might think, that it is perhaps about 2 or in the low 2's rather than 2.5 or 3 percent. So not only is the low unemployment rate signaling something positive in the job markets, but it also is signaling something potentially negative on inflation. This is the famous tradeoff. It cannot be avoided. When the unemployment rate approaches something close to full employment, which is different in every episode and hard to pin down, there will be some demand side inflationary pressures that arise. The trick is to somehow manage policy to sustain growth at low rates of inflation and low rates of unemployment and no one as yet has solved that problem.

The big risk to the economy is the "twin deficits" I alluded to, a major problem. The problem of the twin deficits is the associated debt and interest charges on the debt over time, both Federal Government debt and our debt as a net debtor nation, which can claim an ever-increasing share of GNP and require higher interest rates to attract financing either from abroad or in the United States.

At some point, the large deficits and debt must be associated with high enough interest rates to induce saving and reduce spending. If the deficits were to decline or disappear as a matter of public policy, then the risk would be removed.

The burden of the deficits relative to GNP eventually can be quite considerable, with public debt increasing even at lower levels for the budget deficits, and net foreign debt eventually generating significant interest charges to be paid along with those on the outstanding U.S. Government debt.

The net debtor position announced the other day of $263.5 billion, which represents a very substantial rise from last year, is a sign of a trend which cannot be reversed under current prospects for the trade deficit for at least the rest of the decade and is disturbing. Although overstated because there were capital gains on foreign holdings of U.S. securities and book valuation of some U.S. assets, the increasing debtor position of the United States is something to regard with concern.

Our estimates show a $775 billion net debtor position for the United States by 1990 with $725 billion the net deficit position for securities upon which interest payments must be made. At an interest rate of 7 or 8 percent, the interest payments would be about $50 billion or so. When you add that to the estimate we carry for

the interest charges on outstanding Federal Government debt in 1990, $185 billion, the payments owed together will constitute a considerable claim against the flow of GNP in the U.S. economy.

To reverse this trend requires the Federal budget or the trade deficit, or both, to decline in coming years. On current prospects, such declines are not very likely.

On the budget deficit, for this year, we expect $182.5 billion, but we know that figure includes a one-shot increase in capital gains tax receipts which will not be repeated. So the actual number is probably higher.

For fiscal 1988, depending on the outcome of the congressional resolution on the budget and the back and forth between the administration and Congress and the process which will unwind over the summer, we note that the $37 billion deficit reduction in that resolution, once one allows for some slippage on the spending side, is more like $30 to $32 billion, and that $19 billion of it is a tax increase that the President may not sign. If not signed, $7 billion in defense spending will be cut but the deficit for next year would go to the $180 billion rather than $171.5 billion.

The picture that emerges is a halt in progress in reducing the budget deficits and it is very much locked into the political process as we approach the election in November 1988. Looking at it as an economist, it is not positive for longer run prospects to see the budget deficit declines plateauing out at $180 billion or so for the next few years, which may now be realistic estimates on the current conditions.

The trade deficit is going to improve. We estimate a $25 billion improvement over the year, but that will still leave us with huge trade deficits and increasing debt, leaving the continuing dilemma of the twin deficit and debt problem, ultimately a major source and probably the cause of a downturn in the U.S. economy.

What these deficits do, the budget and trade deficits, is to put monetary and fiscal policy in a very difficult dilemma. Both can be hamstrung. For the Federal Reserve, potential additional weakness in the dollar and/or higher inflation suggest higher interest rates than otherwise would be the case, despite the risk to the economy. With inflation at 4 to 5 percent—that's very high inflation for any other time than the 1970's—the central bank normally would follow a tighter monetary policy, but it can't because it's taking a risk on recession if it were to do that. So it is in a dilemma.

If it tries to ease to produce better growth and lower unemployment, it will cause the dollar to go down, and that would be inflationary. And if it tightens, it runs the risk of recession. Our Federal Reserve is essentially hamstrung with much fewer degrees of freedom than it should have.

For fiscal policy, the dilemma is also one of hamstringing, but a future one. How can fiscal policy be used in the next recession if deficits are so high? Some day there will be another recession and if deficits are $190 billion at that time, they will rise with recession, leaving no fiscal degrees of freedom and making the downturn probably a more difficult one.

In conclusion, I would concur with what the Chairman of the CEA said, policy is the key to sustained expansion. We all know that business expansions do not last forever. Sooner or later, there

must be some sort of a downturn. For our economy, the processes that lead to a recession are beginning to show up. I think the clock has begun to tick away. Let me add that the clock can tick away for several years before a downturn occurs. It can tick for 6 months and then have a downturn. I think this time it's going to be a longer ticking clock, but unless some new magic is discovered in Washington, Bonn, or Tokyo, I think we are running considerable risk as we move toward the end of the decade.

Unfortunately, the combination of policies that would sustain the expansion is no longer simple nor straightforward nor entirely in our hands. Several years ago a simple way out existed through large reductions in the budget deficit when the U.S. economy was growing strongly. Time passed and not enough was done.

I do not fault Congress on this nor would I necessarily fault the administration when I say that not enough was done. Congress has made a considerable amount of progress in reducing the budget deficit in what has been an extraordinarily difficult situation, and you should be commended for what has been accomplished.

A year and a half ago, a much tighter budget, accompanied by substantially easier monetary policy, might have done the trick, although the timing for such a twist of the policy mix would not have been easy. Now, much of the same medicine as before is required, but the rest of the world, especially Japan and Germany, are involved and simultaneous changes of policy must occur there as well to offset any budget restraint. That is very difficult to pull off and will probably become more and more difficult as time goes on.

The starting point for policy to sustain the expansion lies in much bigger budget deficit reductions than Congress and the President are now contemplating. Another gridlock in the budget exists at the moment on the current deficit reduction plan, in my view. Some $50 billion or more of deficit reduction, using a combination of spending reductions in nondefense and defense and tax increases would be appropriate. An offsetting ease of domestic monetary policy would be necessary to prevent the restraint of such a budget tightening from pushing the economy into a recession. Even more is necessary, in this instance, a shift to more stimulative policy in Japan and Germany, and lower interest rates abroad. This is, I think, a-pie-in-the-sky view in terms of what actually could be done realistically to create the set of policies that would sustain the economy through 1990. It's worth stating, hoping in a sense that policymakers may well work their way toward it. As has been evidenced at the various summit meetings in past years, we have made some progress on this front. It's very difficult, but the kind of cooperation and coordination in the United States and across borders and overseas to keep the expansion going for as far as the eye can see I don't think is beyond the realm of possibility; it's just very difficult for the political process to produce it.

[The prepared statement of Mr. Sinai follows:]

PREPARED STATEMENT OF ALLEN SINAI*

State of the Economy and Prospects at Midyear

At midyear 1987, the U.S. and world economies are continuing to expand, albeit in a hesitating manner and with growing risks to sustained expansion. Indeed, in an increasingly intertwined and interrelated global economy, the challenge to Washington, Bonn and Tokyo is to devise and coordinate policies that can sustain noninflationary growth through the end of the decade.

For the U.S. economy, economic growth is now being led by improved foreign trade, a modest industrial sector recovery, an end to the declines in the beleaguered mining and agricultural sectors, and a rebuilding of inventories. This is a healthy development, for just one year ago these areas were in recession or depression. Consumption spending has been weak, especially for autos, but is holding up well in services. Business capital spending, except for computers and office machinery, has declined sharply in reaction to the Tax Reform Act of 1986. Housing activity, starts and sales, is softening in response to higher mortgage rates and increased monthly loan payments, a pattern to be expected at this stage of the business expansion.

For the first half of this year, assuming a 1.3% rise for real GNP in the second quarter, overall growth would average around 3%, about the expectation of the Congressional Budget Office (CBO) and Shearson Lehman Brothers (SLB) coming into this year, at the upper boundary of the central tendency of Federal Reserve expectations, and somewhat below the forecast of the Administration for 1987 (Table 1).

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Table 1
Early 1987 Forecasts for
Economic Prospects for 1987 and 1988
(Dates of Forecast in Parenthesis)

	Administration (1/87)		CBO (1/87)		Federal Reserve† (2/87)	SLB (12/86)	
	1987	1988	1987	1988	1987	1987	1988
Economy (% Change Fourth-Quarter to Fourth-Quarter)							
Nominal GNP	6.9	7.2	6.5	—	5-3/4 to 6-1/2	6.8	7.6
Real GNP	3.2	3.7	3.0	2.9	2-1/2 to 3	3.0	3.2
Inflation (% Change Fourth-Quarter to Fourth-Quarter)							
Implicit GNP Price Deflator	3.6	3.5	3.4	4.0	3 to 3-1/2	3.7	4.3
Unemployment Rate (%, Avg. Level in the Fourth Quarter)	6.5	6.3*	6.6	6.5	6-1/2 to 6-3/4	6.7	6.2
Interest Rates (%)							
91-Day Treasury Bill*	5.4	5.6	5.6	5.7	—	5.3	5.8
10-Year Treasury Note*	6.7	6.6	7.2	7.2	—	7.3	7.6

† Central tendency.
* Calendar years.

As had been expected, a turn in real net exports and improved production in the industrial sector have provided the upward thrust to growth. Exports, orders, production, employment and inventories all have been stronger. An expected $27.6 billion swing for real net exports and $47 billion rise of inventories over the first half account for all of the increase in real GNP this year.

Overseas, economic growth generally has been sluggish, but the worst seems to have passed. The German and French economies are off to a slow start this year. In Germany, real growth fell at near a 3% annual rate in the first quarter, but a strong uptick has occurred at the start of the second. Italy is growing moderately. The U.K. has been the best performer so far, with growth likely to be 3-1/2% to 4% for the year. The Japanese economy offered evidence in the first quarter that the adjustment to a weak industrial sector was nearing an end, with real GNP rising at a 4.9% annual rate. Taiwan, Korea and Hong Kong are growing robustly, led by exports.

Inflation in the U.S. is considerably worse this year, rising at annual rates of 4% to 6% between December and May, regardless of the index. Precious metals, oil and commodity prices all are substantially higher as well. Expectations of inflation generally were 3% to 4% coming into this year.

The worse inflation so far this year principally represents the direct and indirect effects of a lower dollar and higher oil and energy prices. About a 25% decline in the dollar against a trade-weighted average of foreign currencies since September 1985 is having numerous effects on inflation. First, there is the direct effect on imported goods prices, such as automobiles and consumer electronics, of higher import prices. Second, there is an "umbrella" effect resulting from higher prices of U.S. goods in categories where import prices have risen considerably. Third, business costs are higher off the lower dollar since so much materials and inputs to production are purchased abroad. Fourth, precious metals and commodities prices have been driven up as a result of generalized increases in the purchasing power of strong currency countries. The supplies of commodities such as oil, where payments occur in dollars, can be limited in order to produce adequate dollar-adjusted revenues. Fifth, the lower dollar is helping to strengthen the U.S. industrial sector, adding to demand-side pressure and making it easier for American business to pass on price increases. A rise in crude oil prices, from $14 a barrel last November to about $20 per barrel now also has been a major source of the higher inflation, although not unrelated to the decline in the dollar. Inflation rates have stepped up in Europe and the Far East as well, most likely a consequence of higher oil and energy prices.

The higher inflation and a shift of funds away from U.S. fixed income markets by foreign investors have caused significant rises for longer-term interest rates, up about one percentage point and more since the end of 1986. With inflation now on a higher plateau, so are long-term interest rates. Typically, once a reacceleration of inflation begins, interest rates trend irregularly higher, on average. Short-term interest rates are about one-half percentage point higher, reflecting central bank defense of a weak dollar and the higher inflation. Expectations generally had been that interest rates would not rise over the first half. There was a widespread view that rates would move lower, perhaps significantly so.

Sustained growth, a better balance in the components of expenditures, improving foreign trade, a stronger industrial sector, and good profits results represent the good news on the U.S. economy so far this year. Continuing large and seemingly intractable federal budget deficits, only a slow turn in trade, downside risks to the dollar, worsening inflation, and higher interest rates are the negatives and risks facing the economy.

The possibility of yet higher inflation and potentially higher interest rates has increased the risk of a recession in the next six to fifteen months to 1-in-4 from an assessment of 1-in-10 at the beginning of the year. Whether the expansion lasts six more months or through the end of the decade now depends very much on the policy choices of the major economic powers—the U.S., Japan and Germany—in order to deal with the external and internal imbalances that face them. The future of the U.S. economy no longer only resides with the U.S.; policy coordination between countries is more necessary than ever to keep worldwide expansion going.

Most troubling and risky is the continued lack of progress in dealing with a budget impasse that threatens to leave the federal budget deficit at $180 billion to $200 billion over the next few years. These deficits—the result of the large tax cuts of the 1980s, slower than potential growth, and large increases in government spending—if sustained, will leave the U.S. with too few fiscal degrees of freedom should a slowdown or recession arise. Still high trade and current account deficits, although improving gradually, also represent a risk—principally to the dollar, inflation and interest rates; thus, also to the economy. Though not an immediate threat to an expansion which actually looks more well-entrenched now, the "twin deficits"—budget and trade—and associated debt, higher inflation, and possibly higher interest rates may have started the clock ticking on the next recession, most likely to occur in 1989 or 1990.

Tables 2 to 5 present the current Shearson Lehman forecast and assumptions for the U.S. economy and financial markets and for the rest-of-the-world economies and financial markets through the balance of this year, 1988 and 1989.

The Economy at Midyear and Prospects—Reasonably Good Growth With Better Balance

So far this year and in coming quarters, the theme for the economy is reasonably good growth with better balance. The areas of activity previously weakest are now stronger; those categories of spending previously strongest are weaker. In particular, real net exports have responded to a lower dollar, rising $29.6 billion between the third quarter of 1986 and the first quarter of 1987, with a further improvement of $28.2 billion forecast over the remainder of the year. Exports, in real terms, are up $36.9 billion since mid-1986, pretty much across-the-board, stimulating the U.S. industrial sector to produce more, both for inventories and sales, as well as increasing the flow of orders and firming up employment. Between mid-1984 and mid-1986, declines for real net exports totalled $76.9 billion, subtracting some 1-1/2 percentage points per annum of economic growth from the economy. The mining and agricultural sectors appear to be over the worst. With manufacturing, mining and agriculture improving, the drag of these sectors on growth has come to an end. A still strong services economy, despite weak spending in the aggregate on consumption, business plant and equipment and residential construction, continues to sustain the growth momentum of the economy.

For the rest of this year and in 1988, continuing improvement in real net exports and an expansion in the industrial sector are expected to provide the major thrust to growth. Consumer spending, weak so far this year, although only in autos and some other big-ticket items, is expected to rebound to a 2% or 3% pace of growth, nowhere near the boom figures of 3.5% and 4.1% in 1985 and 1986, respectively, but sufficient to keep driving the economy up. Business capital spending should remain soft for much of this year, especially in commercial construction, but then is projected to rise 3.5% in 1988. Federal government spending, in real terms, is expected to depress growth, rising very little.

Table 2
Shearson Lehman Forecast of the U.S. Economy and Financial Markets
June 22, 1987
(Probability=0.65)

	Quarters						Years			
	1986:4	1987:1	1987:2	1987:3	1987:4	1988:1	1986	1987	1988	1989
Gross National Product-1982 Dollars	3696.1	3739.5	3751.9	3777.0	3809.6	3838.8	3675.0	3769.5	3883.4	3917.3
Annual Rate of Change	1.1	4.8	1.3	2.7	3.5	3.1	2.5	2.6	3.0	0.9
Percent Change Year Ago	2.0	2.3	2.5	2.5	3.1	2.7	2.0	3.1	3.1	1.3
Consumption	2445.8	2438.8	2452.2	2469.8	2491.2	2503.0	2418.7	2463.0	2530.8	2548.4
Annual Rate of Change	-0.4	-1.1	2.2	2.9	3.5	1.9	4.1	1.8	2.8	0.7
Business Fixed Investment	457.8	446.3	451.2	449.2	448.7	453.7	456.7	448.9	464.6	477.6
Annual Rate of Change	3.0	-9.7	4.5	-1.8	-0.4	4.5	-1.0	-1.7	3.5	2.8
Residential Construction	199.7	197.3	195.6	193.8	193.0	195.0	194.0	194.9	193.9	187.2
Inventory Investment	-28.5	40.7	18.5	16.0	15.7	16.8	6.6	22.7	19.3	15.7
Net Exports	-148.0	-133.7	-121.2	-115.4	-105.5	-99.2	-147.8	-119.0	-95.2	-89.4
Federal Government	348.6	325.3	329.0	335.7	337.8	338.9	332.2	332.0	334.5	334.8
Annual Rate of Change	23.2	-24.2	4.6	8.4	2.5	1.3	2.7	-0.1	0.8	0.1
State and Local Government	420.7	424.8	426.6	427.9	428.7	430.6	414.6	427.0	435.5	443.0
Annual Rate of Change	1.1	4.0	1.7	1.2	0.7	1.8	4.3	3.0	2.0	1.7
Industrial Production (1977=1.000)	1.259	1.268	1.278	1.289	1.305	1.320	1.251	1.285	1.345	1.366
Annual Rate of Change	2.9	2.9	3.2	3.5	5.1	4.7	1.0	2.7	4.6	1.6
Housing Starts (Mil. Units)	1.701	1.795	1.630	1.650	1.671	1.651	1.819	1.687	1.616	1.575
Auto Sales-Total (Mil. Units)	11.5	9.8	9.7	11.0	10.5	10.8	11.6	10.3	11.2	10.2
Unemployment Rate-Civilian (%)	6.8	6.7	6.3	6.3	6.2	6.1	7.0	6.4	5.9	6.3
Federal Budget Surplus Unified (Quarterly Rate, NSA, FY)	-64.4	-58.6	-15.7	-43.9	-63.6	-57.0	-220.7	-182.5	-171.8	-175.5
Implicit Price Deflator (%CH)	0.7	4.2	4.5	4.9	4.8	4.5	2.6	3.5	4.2	4.6
CPI- All Urban (%CH)	2.7	5.3	5.1	4.4	4.5	5.4	1.9	3.8	4.6	4.9
PPI-Finished Goods (%CH)	2.5	3.2	5.6	5.2	5.4	5.2	-1.4	2.9	4.8	5.0
Hourly Earnings (%CH)	2.9	2.0	2.7	3.0	3.5	3.8	2.4	2.4	3.3	3.6
Trade-Weighted Exchange Rate	1.027	0.971	0.942	0.940	0.942	0.950	1.060	0.949	0.974	0.986
Annual Rate of Change	-0.3	-20.1	-11.4	-0.8	0.9	3.4	-16.7	-10.5	2.7	1.2
Merchandise Trade Balance (Bils. $'s)	-171.5	-163.9	-153.2	-130.5	-126.4	-119.0	-166.3	-143.5	-111.0	-97.5
Corporate Profits Aftertax (Bils. $'s)	144.5	138.8	141.1	148.9	154.2	158.9	134.0	145.8	158.9	164.1
Percent Change Year Ago	3.7	9.4	9.5	9.6	6.7	14.5	2.0	8.7	9.0	3.3
Adjusted Profits Aftertax (Bils. $'s)	196.1	206.6	206.1	211.4	214.2	212.9	197.1	209.6	210.4	209.1
Percent Change Year Ago	3.6	2.9	6.1	7.0	9.2	3.0	4.4	6.3	0.4	-0.6
Real Disposable Income (Bils. $'s)	2596.6	2612.1	2594.9	2627.5	2652.1	2679.6	2602.3	2621.7	2721.6	2784.5
Annual Rate of Change	-1.4	2.4	-2.6	5.1	3.8	4.2	2.9	0.7	3.8	2.3
Personal Saving Rate (%)	2.6	2.8	2.2	2.7	2.7	3.2	3.9	2.6	3.6	5.0
M2 (Bils. $'s)	2778.6	2822.5	2841.1	2880.1	2927.1	2977.8	2778.6	2927.1	3135.0	3335.0
Annual Rate of Change	9.5	6.5	2.7	5.6	6.7	7.1	8.9	5.3	7.1	6.4
Prime Rate (%)	7.50	7.50	8.05	8.33	8.67	9.00	8.33	8.14	9.38	9.50
Federal Funds Rate (%)	6.27	6.22	6.65	6.81	7.08	7.34	6.81	6.69	7.75	8.05
3-Month Treasury Bill (%)	5.35	5.54	5.64	5.78	5.97	6.29	5.98	5.73	6.65	7.45
10-Year Treasury Note (%)	7.26	7.19	8.33	8.17	8.48	8.87	7.68	8.04	9.18	9.41
30-Year Treasury Bond (%)	7.53	7.49	8.53	8.41	8.74	9.07	7.80	8.29	9.43	9.68
New AAA-Equiv. Corporate Bonds (%)	8.43	8.13	9.50	9.47	9.80	10.07	8.62	9.23	10.07	10.19
Bond Buyer Index (%)	6.93	6.63	7.71	7.62	7.77	7.96	7.32	7.43	8.45	9.31
S&P 500 Index of Common Stocks	242.97	279.31	293.73	315.88	313.95	306.45	236.17	300.72	322.83	300.93
Annual Rate of Change	3.1	74.6	22.3	33.8	-2.4	-9.2	24.6	27.3	7.4	-6.8
Earnings Per Share - S&P 500 ($)	2.96	4.47	4.01	4.79	4.99	5.20	14.48	18.26	20.59	21.40
Percent Change Year Ago	-11.1	17.0	5.0	23.5	68.6	16.3	-0.9	26.1	12.8	3.9
Price-Earnings Ratio - S&P 500	16.8	18.5	19.2	19.5	17.2	16.1	16.3	16.5	15.7	14.1

Forecast Assumptions—U.S. Economy and Financial Markets

Fiscal policy—budget and taxes: With or without the Gramm-Rudman-Hollings statute, fiscal policy is no longer providing much stimulus to the economy. Under the Shearson Lehman economic outlook and current law ("current services budget"), the deficits without GRH would be $210 billion, $205 billion, and $202 billion for FY1988 to FY1990. The averages of the Administration and CBO forecasts as of January 1987 were $160 billion for FY1988, $155 billion for FY1989, and $130 billion for FY1990.

Even with $30 billion of estimated budget savings from the revenue gains of tax reform (including about $15 billion of one-shot capital gains receipts), the 1986 Reconciliation Act and other changes, the budget deficit is estimated by CBO and the Administration to be near $175 billion in FY1987. In FY1988, the Administration has projected a deficit of $107.7 billion, just under the GRH target. The CBO estimate is $134 billion.

Given over-optimistic economic and interest rate assumptions by the government, deficit reductions that may not be realized in reconciliation, and underestimates of defense and agriculture spending, the Shearson Lehman forecast of the FY1987 unified budget deficit is $182.5 billion. For FY1988, the forecast is $171.8 billion, assuming about $35 billion of bona fide budget tightening— defense and nondefense spending cuts, and higher excise and energy taxes. The joint resolution of June 18 has a $19 billion tax hike. If not approved, the FY1988 deficit would be $190 billion.

The deficits over the next few years are likely to be well above the GRH targets. Under Shearson Lehman's current services baseline, the requisite cuts, at $102 billion in FY1988, $133 billion in FY1989 and $166 billion in FY1990, are huge and improbable. Actual reductions of about $35 billion in FY1988, $40 billion in FY1989 and $15 billion in FY1990 are assumed.

Over five years, the Tax Reform Act of 1986 is essentially growth-neutral for the economy. But, for calendar 1987, a net $20 billion tax increase (about a $23 billion tax hike on business and a $3 billion tax cut for households—net of higher capital gains taxes, which are estimated at $30 billion in 1987) will be restrictive, with negatives on business capital spending and commercial construction outweighing the positive effects on consumption which will be slower to develop.

Real economic growth in 1987 is 0.5 percentage points lower than otherwise because of the tax bill, especially in the first half. Growth should be a little higher in 1988 and 1989, because taxes, net, are reduced, with cuts of $30 billion and $36 billion for households vs. increases of $25 billion and $27.5 billion for business. Growth in business fixed investment is three percentage points lower in 1987 from the tax bill, then begins to return to the pre-tax bill track. Consumer spending picks up in the second half of 1987 and in 1988 from the tax bill. Growth in corporate aftertax profits is less in 1987.

Monetary policy: Neutral to somewhat restrictive through the rest of the year because of higher inflation and to support the dollar. With the dollar still a concern, the central bank is seen as leaning toward restriction, though cautious on taking action. Along with economic growth, the dollar is fundamental for the Fed. With more concern on inflation this year, 4-1/2% or so is a trigger for tightening. One hike in the discount rate is indicated in the fourth quarter. The new Chairman, Alan Greenspan, is likely to show anti-inflation stripes early.

Policy mix: The "loose fiscal-tight money" policy mix in place from 1981 to 1985 has shifted. Fiscal policy is being gradually tightened and monetary policy has been easier. The reductions of the budget deficits set into motion over 1982 to 1985 and the suspension of monetary growth targeting produced a lower profile of interest rates, higher equity prices, and a weaker dollar than otherwise would have been the case. Given this twist in the policy mix, some rebalancing of the economy's imbalances has been occurring, with interest- and dollar-sensitive sectors such as trade, net exports, and manufacturing performing better.

Oil prices: Relatively stable oil markets over the next few months, with crude oil prices between $19 and $20 per barrel for North Sea Brent and West Texas Intermediate crudes and near $19 a barrel for refiners' acquisition costs. The current OPEC Agreement holds through midyear and a new one is set thereafter. The $11 a barrel net drop in refiners' acquisition costs between November 1985 and November 1986 reduced inflation by several percentage points in 1986, fully offsetting the inflationary effects of a lower dollar. A deflationary effect on business costs lingers in 1987, but inflation rates rise from the latest oil price hikes and the declines in the dollar. A range of $18 to $21 a barrel is projected for oil prices in all of 1987, $19 to $22 a barrel in 1988, and $21 to $25 a barrel in 1989.

Commodity prices: Higher commodities prices as the industrial sector revives and inflation heats up, especially in precious metals from the lower dollar. No runaway surge, however, reflecting the still large supplies and slack demands in many economies throughout the world.

Wages and unit labor costs: In general, continuing modest rises in wages this year because of economic slack, the effects of deregulation, intense product and labor market competition, and the decline in union strength. A tough stance by management is assumed to keep rises in wages on a low track. Productivity growth should pick up with increased industrial output. Unit labor cost increases of 2% to 3% for 1987 are expected; more in 1988 as wages pick up. Modest rises in labor costs are a major factor limiting inflation.

Third World debt and bank problems: Brazil will reach an accommodation with the IMF on its "New Plan Cruzado" to realize easier loan terms. Citibank's reserving of $3 billion against Brazilian loans signaled a tougher stance by major banks that can force liquidity and solvency to be maintained by all major borrowers. Mexico will boost growth in 1987 prior to the 1988 elections, setting up another payments crisis in 1988. South Korea should move off the list of problem countries as its current account balance stays in surplus, but political unrest makes the situation uncertain. A trend to swap debt for equity and eventually to securitize LDC loans can help ease debtor countries' problems. Firmer commodity prices also help, but slower U.S. imports assures that LDC debt problems remain.

Growth in the rest-of-the-world economies: With sluggish growth abroad, Germany and Japan can be expected to gradually undertake more expansionary fiscal policies. The G-5 Accord and Venice Summit keep the pressure on. Unemployment declines a little in Europe, but continues to be a major economic problem. In Japan, unemployment will rise to record highs. The interest rate declines abroad seem to be over.

The dollar and trade legislation: A more stable dollar from now until year-end on the fundamentals, especially wider yield differentials. Big downside risks are being limited by actions of the major trading partners. Rotating, coordinated intervention periodically occurs and minor policy adjustments keep the dollar fluctuating between 1.75 and 1.90 deutschemarks, 140 to 150 yen, 5.90 to 6.20 French francs, and 1.60 to 1.70 on the British pound sterling. Some further testing of the dollar yet is projected over the summer. If interest rate reductions do not hold abroad or the U.S. trade deficit does not show significant improvement, the dollar would push toward new lows again, heading for 1.65 deutschemarks, 130 yen, less than 5.75 francs, and over 1.70 on the pound sterling. "Hard-landing" dollar scenario seems to have gone by the wayside now.

Trade frictions are assumed to mount in 1987. Protectionist legislation occurs by August, but not in a severe form, as a compromise between the Senate trade bill and Administration proposals is reached.

Table 3
World Outlook Summary
(History and Shearson Lehman Forecast)
June 22, 1987

	Real Growth* (Percent Change)				Inflation- Consumer Prices (Percent Change)				Unemployment Rate (Percent)				Current Account Balance** (Billions of U.S. Dollars)			
	1985	1986	1987	1988	1985	1986	1987	1988	1985	1986	1987	1988	1985	1986	1987	1988
United States	2.7	2.5	2.6	3.0	3.5	1.9	3.8	4.6	7.2	7.0	6.4	5.9	-117.7	-141.4	-126.5	-115.9
Canada	4.0	3.1	2.3	2.8	4.0	4.2	4.3	4.1	10.5	9.6	9.4	9.0	-8.9	-6.7	-3.2	-3.7
Europe	2.6	2.4	2.6	2.8	5.1	2.4	3.1	3.5	10.4	10.5	10.7	10.3	20.0	47.6	38.1	29.7
France	1.7	2.2	2.0	2.5	5.8	2.5	3.7	4.1	10.4	10.8	11.4	11.1	-0.2	3.6	5.0	5.5
West Germany	2.5	2.4	1.7	2.3	2.2	-0.2	0.7	1.2	9.3	8.9	9.1	8.9	15.2	35.2	25.0	20.2
Italy	2.7	2.7	3.0	3.3	8.6	6.1	4.6	5.0	12.9	13.8	14.4	13.7	-4.2	3.0	2.2	-1.5
Switzerland	3.7	2.8	3.0	2.8	3.4	0.8	1.9	2.1	1.0	0.8	0.9	1.0	5.2	7.4	8.6	9.0
United Kingdom	3.5	2.3	3.9	3.3	6.1	3.4	4.8	6.0	11.8	11.9	11.1	10.6	4.0	-1.6	-2.7	-3.5
Far East	4.6	3.3	3.2	3.4	2.4	1.5	1.5	2.1	—	—	—	—	49.6	97.4	76.6	70.7
Japan	4.7	2.5	2.7	3.2	2.0	0.6	0.8	1.5	2.6	2.8	3.1	3.3	49.2	85.9	70.0	65.0
South Korea	5.4	12.2	7.1	6.7	2.5	2.3	2.6	2.9	—	—	—	—	-0.6	4.6	4.5	4.7
Taiwan	4.3	9.9	7.8	6.5	0.4	0.7	-0.2	1.1	—	—	—	—	9.2	16.1	9.0	7.0
Hong Kong	0.6	8.7	6.9	5.1	2.6	2.8	4.2	4.7	—	—	—	—	0.5	0.1	1.0	1.0
Singapore	-1.8	1.9	2.8	3.8	0.5	-1.4	0.1	0.8	—	—	—	—	0.0	0.5	-1.2	-1.5
Australia	5.1	1.5	2.4	2.3	6.7	9.1	7.5	6.8	8.2	8.1	8.3	8.0	-8.7	-9.8	-6.7	-5.5
Latin America	4.0	2.7	2.4	3.0	197.8	103.3	147.9	123.5	—	—	—	—	3.8	-8.6	-7.0	-4.7
Argentina	-4.8	5.9	2.5	3.3	672.2	90.1	108.6	103.2	—	—	—	—	-1.0	-3.2	-3.0	-1.6
Brazil	8.3	7.8	3.1	4.1	225.5	142.3	215.8	181.5	—	—	—	—	-0.3	-2.5	-1.9	1.2
Mexico	2.7	-3.3	1.7	2.1	57.7	86.2	113.1	89.5	—	—	—	—	1.2	-1.3	-2.4	-3.5
Venezuela	0.3	-2.0	1.3	1.5	9.1	10.6	22.7	16.2	—	—	—	—	3.9	-1.6	0.3	-0.8
All Countries Listed	3.2	2.7	2.7	3.0	15.3	8.1	11.8	11.0	—	—	—	—	-45.2	-111.7	-22.0	-23.9
OECD Countries Listed	3.1	2.5	2.6	3.0	3.8	2.1	3.2	3.9	7.4	7.3	7.2	6.8	-58.1	-24.4	-28.3	-30.4
EEC	2.6	2.4	2.5	2.8	5.2	2.5	3.2	3.8	10.8	11.0	11.1	10.8	14.8	40.2	29.5	20.7

* Real GNP or GDP, depending on the country

** Hong Kong, trade balance

Forecast Assumptions—Rest of the World

France: Pre-campaigning for the March 1988 Presidential elections will become more important over the rest of the year. If Mitterand runs, the Socialists stand a good chance of recapturing the Presidency. In any case, fiscal policy along current lines should remain in place. The 1987 budget is the first in 28 years to cut real expenditures. The deficit will shrink to 2-1/2% of projected GDP in 1987 from 3% in 1986, and the government plans to reduce the deficit by Fr 15 billion in each budget to 1989. Tax reform will lower both personal and corporate rates but expand the tax base. Monetary policy has shifted to interest rate management in 1987 after many years of direct credit and foreign capital controls. Targets of 3% to 5% for M2 match with anticipated 5% growth of nominal GDP, and nominal interest rates should decline to catch up with the deceleration of inflation that occurred in 1986. The franc should remain strong against the dollar, trading in the Fr 5.90 to Fr 6.20 range.

Germany: The victory of the center-right coalition in the January 25 election has kept in place a continuation of the Kohl government's broad economic policies of fiscal and monetary conservatism. Government spending is expected to remain flat in 1987 and the deficit will rise slightly from 1986 as a share of GNP. The government will propose tax reform for debate in 1987 and implementation in 1988. Previously scheduled tax cuts for 1990 are to be stepped up and enlarged, perhaps by $4 billion to $5 billion. The 1987 growth targets for Central Bank Money—set at 3% to 6%—are being exceeded so far this year, perhaps due to dollar support operations. As a result, the Bundesbank has permitted somewhat lower short-term interest rates as a way to support the dollar and to stimulate the weak German economy, but is making no further changes in policy-related rates. The deutschemark will remain strong against the EMS currencies and the dollar in 1987, ranging from DM 1.75 to DM 1.90 vs. the dollar and stabilizing near DM 1.90 by year-end.

Italy: The Italian election results in June indicate that the five-party coalition government will probably be renewed. No major new policy initiatives seem possible until the political situation becomes more settled. The 1987 budget calls for a modest reduction in the public sector deficit to Lit 100 trillion from Lit 110 trillion last year. Interest rate reductions should catch up with the deceleration of inflation that occurred in 1986 and match those elsewhere in Europe, but real rates will remain high as public financing bumps against fixed ceilings on domestic credit. The exchange rate should fluctuate between Lit 1250 and Lit 1350 against the dollar while slowly sliding against the deutschemark. The trade and current account deficits are expected to remain positive in 1987, then to turn negative during 1988.

United Kingdom: The victory of Thatcher's Conservatives in the June election reaffirms the policies that have produced a relatively strong performance for the U.K. economy, including a relaxed posture on money growth. The 1987/88 budget reduced personal and corporate taxes but still lowered the public sector borrowing requirement (PSBR) because of better-than-expected tax receipts. However, net public sector savings —PSBR plus the revenues from asset sales—remain expansionary. Revenues will continue to be enhanced by sales of public assets through 1989. Monetary policy will be keyed on the value of the pound, providing room for stable to lower short-term interest rates. Firmer oil markets in 1987 and improving trade should keep the pound sterling strong. High wage increases point to more inflation by the end of this year, however, and are symptomatic of a major problem still facing the British economy—an upward inflationary bias. Excessive money growth also is a future danger sign for inflation.

Japan: Trade relations have gained in domestic political importance. The yen rise has produced an industrial recession and Japanese industry has been adjusting for almost two years now. The budget for fiscal 1987/88 was the most austere in 22 years with virtually no increase in overall expenditures. But, in line with the Paris Agreement and Venice Summit, a new fiscal stimulus of ¥6 trillion ($43 billion) is promised, to be carried forward in a summer budget supplement. Tax reform is not completely dead, with personal and corporate reductions proposed in the latest Nakasone fiscal package. But the value-added (sales) tax has been discarded. Monetary growth is running over 9% despite low inflation and sluggish growth, and the Bank of Japan (BOJ) is holding firm now. The BOJ will intervene as needed to try and hold the exchange rate between ¥140 and ¥150 to the dollar. If the U.S. trade deficit does not improve as the year progresses, the exchange rate could slip to ¥130 or so (worst case).

Canada: The FY1986/87 budget fell short of its goal to bring public borrowing under C$30 billion, and the FY 1987/88 budget barely delivers last year's promised fiscal deficit. Tax reform for 1988 and 1989 has been announced, with a shift in the tax burden from individuals to corporations. Monetary policy is committed to defending the Canadian dollar, which has forced rates to rise with U.S. rates. Capital inflows from Japan and Europe may not be maintained, putting downward pressure on the currency. Trade negotiations with the U.S. should produce some results by October 1987.

East Asia: The stellar growth of 1986 will continue, but at a somewhat dampened pace in 1987 and 1988. Taiwan will see foreign demand slacken in 1987 and 1988 as the U.S. and Japan cut back on import demand, but will still grow nicely. South Korea should have another strong year if politics permit, as new industries open up export opportunities—especially in cars and electronics—and export-led growth continues. Hong Kong should benefit from China's improved import position. Generally, exports should lead this economy up as well. Singapore's recovery from the 1985-86 recession will solidify in 1987, but not enough to return the country to its historically high growth rates.

Latin America: Brazil's interest payment moratorium has soured relations between borrowers and lenders, but limited new lending to Latin America is continuing. Citibank's $3 billion reserve buildup is clearly linked to Brazil's recalcitrance, and changes the bargaining power balance in favor of banks.

Brazil has announced a new plan to bring its economy back to normal, which will almost certainly be endorsed by the IMF and will guarantee new loans for Brazil both from the IMF and its commercial creditors. Argentina has received new loans of about $2 billion from commercial banks and almost $4 billion from the IMF and the World Bank and a restructuring of its debt. Oil exporters like Venezuela and Ecuador will need new cash.

Mexico will elect a new president in 1988 and politics could turn less flexible to the country's creditors as early as mid-1987. National elections are also expected in Brazil and Argentina within the next 18 months.

Inflation remains a symptom of general economic decay in all the major Latin economies, and will run in triple- or double digits except for times of freezes. Debt-for-equity swaps likely will become an important source of debt relief over the next two years through the discount market, and some form of securitization of LDC debt likely will be implemented. Commercial banks will continue to increase reserves against Latin American loans, likely at an accelerated pace because of Brazil.

Table 4
Recent History and Prospects for the U.S. and World Economy
Interest Rates
June 22, 1987

	1985:3	1985:4	1986:1	1986:2	1986:3	1986:4	1987:1	1987:2	1987:3	1987:4	1985	1986	1987	1988
Short-Term Rates														
United States	7.1	7.2	6.9	6.1	5.5	5.4	5.5	5.6	5.8	6.0	7.5	6.0	5.7	6.7
Japan	6.3	7.0	6.0	4.7	4.7	4.5	4.0	3.7	3.6	3.6	6.5	5.0	3.7	3.9
West Germany	4.9	4.8	4.6	4.6	4.5	4.7	4.1	3.7	3.5	3.6	5.4	4.6	3.7	3.8
France	9.8	9.1	8.7	7.4	7.1	7.6	8.1	7.7	7.6	7.6	9.9	7.7	7.8	7.8
United Kingdom	11.0	11.2	11.6	9.5	9.6	10.9	10.5	8.9	8.4	8.6	11.6	10.4	9.1	9.1
Canada	8.9	8.9	10.8	8.6	8.4	8.4	7.4	8.0	8.4	8.5	9.4	9.1	7.9	8.8
Long-Term Bond Yields														
United States	10.6	10.0	8.8	7.5	7.4	7.5	7.5	8.5	8.4	8.7	10.8	7.8	8.3	9.4
Japan	6.1	6.3	5.2	4.9	5.1	5.4	4.9	3.2	3.2	3.4	6.3	5.2	3.7	3.8
West Germany	6.5	6.5	6.1	5.7	6.1	6.0	5.8	5.6	5.7	5.9	6.9	6.0	5.8	6.0
France	11.7	11.3	10.3	8.2	7.9	8.4	8.7	8.8	9.2	9.2	11.7	8.7	8.9	9.2
United Kingdom	9.9	9.9	9.5	8.7	10.0	11.3	9.9	9.1	9.0	9.0	10.1	9.9	9.3	9.4
Canada	10.9	10.4	10.0	9.4	8.9	8.9	8.3	9.1	9.3	9.4	11.0	9.3	9.0	9.6

Notes: Data are period averages; annual data are averages of quarterly values. *Short-term rates:* United States—3-month Treasury bill yield; Japan—Gensaki 3-month rate; West Germany—3-month bill rate; France—3-month government acte (pension); United Kingdom—91-day Treasury bill yield; Canada—3-month Treasury bill rate. *Long-term rates:* United States—average yield on government bonds with 30-year maturity; Japan—yield on benchmark 10-year bond; West Germany—yield on most recent issue 10-year bond; France—average yield on 10-year government bonds; United Kingdom—yield on 10-year gilts; Canada—yield on 10-year government bonds.

Source: History—OECD Main Economic Indicators and Shearson Lehman Economics; Forecast—Shearson Lehman Economics.

Table 5
Dollar, Yen, Deutschemark, French Franc, Pound, and Canadian Dollar Exchange Rates and Cross Rates
June 22, 1987

	1985:3	1985:4	1986:1	1986:2	1986:3	1986:4	1987:1	1987:2	1987:3	1987:4	1985	1986	1987	1988
Exchange Rates														
U.S.$ (Weighted Avg.)	1.249	1.173	1.117	1.067	1.028	1.027	0.971	0.942	0.940	0.942	1.272	1.060	0.949	0.974
Japan (¥/$)	238.4	207.2	187.8	169.9	155.8	160.5	153.1	142.8	140.5	144.7	238.5	168.5	145.3	149.9
Germany (DM/$)	2.847	2.584	2.348	2.245	2.085	2.006	1.840	1.807	1.795	1.845	2.944	2.171	1.822	1.929
France(Fr/$)	8.681	7.886	7.212	7.141	6.779	6.571	6.121	6.037	6.017	6.161	8.987	6.926	6.084	6.292
UK ($/£)	1.376	1.435	1.441	1.509	1.488	1.438	1.542	1.644	1.651	1.612	1.296	1.467	1.612	1.598
Canada (C$/$)	1.360	1.380	1.404	1.385	1.386	1.385	1.338	1.334	1.320	1.335	1.370	1.390	1.332	1.355
£ Cross Rates														
Japan (¥/£)	328.0	297.3	270.6	256.4	231.8	230.8	236.1	234.8	232.0	233.3	309.1	247.2	234.2	239.5
Germany (DM/£)	3.917	3.708	3.383	3.388	3.102	2.885	2.837	2.971	2.964	2.974	3.815	3.185	2.937	3.083
France(Fr/£)	11.945	11.316	10.392	10.776	10.087	9.449	9.439	9.925	9.934	9.932	11.647	10.160	9.809	10.055
Canada (C$/£)	1.871	1.980	2.023	2.090	2.062	1.992	2.063	2.193	2.179	2.152	1.776	2.039	2.147	2.165
DM Cross Rates														
Japan (¥/DM)	83.74	80.19	79.98	75.68	74.72	80.01	83.21	79.03	78.27	78.43	81.01	77.61	79.70	77.71
France(Fr/DM)	3.049	3.052	3.072	3.181	3.251	3.276	3.327	3.341	3.352	3.339	3.053	3.190	3.340	3.262
UK (£/DM)	0.255	0.27	0.296	0.295	0.322	0.347	0.352	0.337	0.337	0.336	0.262	0.314	0.341	0.324
Canada (C$/DM)	0.478	0.534	0.598	0.617	0.665	0.690	0.727	0.738	0.735	0.724	0.465	0.640	0.731	0.702
¥ Cross Rates (Per 100 Yen)														
Germany (DM/¥)	1.194	1.247	1.250	1.321	1.338	1.250	1.202	1.265	1.278	1.275	1.234	1.288	1.255	1.287
France(Fr/¥)	3.641	3.806	3.840	4.203	4.351	4.094	3.998	4.228	4.283	4.258	3.768	4.110	4.191	4.197
UK (£/¥)	0.305	0.336	0.370	0.390	0.431	0.433	0.424	0.426	0.431	0.429	0.324	0.405	0.427	0.417
Canada (C$/¥)	0.570	0.666	0.748	0.815	0.890	0.863	0.874	0.934	0.940	0.923	0.574	0.825	0.918	0.904

Source: History—OECD Main Economic Indicators and Shearson Lehman Economics; Forecast—Shearson Lehman Economics.

Overall, a 3.1% pace of growth is expected for 1987, fourth quarter-to-fourth quarter, led by real net exports, inventory investment, and state and local government spending. A $28.8 billion improvement in real net exports and $16.1 billion rise for inventories in 1987 account for 1-1/2 percentage points of the expected 2.6% growth rate in 1987, calculated on an average annual basis.

For 1988, a similar forecast holds, 3%+ on growth, but with a better pace in consumption and business fixed investment. Improving real net exports should push the industrial sector higher, increasing utilization rates and inducing more capital expenditures. A $30 billion tax cut for households next year is expected to push consumption higher, especially in services and nondurable goods.

The sustained growth depicted in the forecast depends on continuing improvement in trade and the industrial sector, and a pickup for consumer spending over the rest of the year. A stronger industrial sector and improved pace of capital spending is expected to help growth in 1988.

A reasonably strong increase for industrial production and inventories are key ingredients in the sustained growth that is indicated in the forecast. But, for this to occur, trade and real net exports must keep rising. At some point, consumers and American businesses need to substitute domestic goods for foreign goods in order to provide the expected lift to the economy.

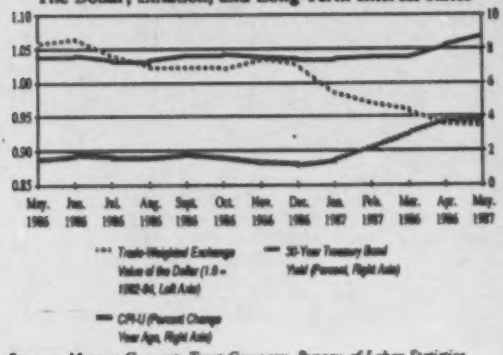
Inflation and Interest Rates—Higher Plateau

Perhaps the biggest change since the beginning of the year has been the sharply higher inflation and higher interest rates that have arisen. A weaker dollar, higher oil and energy prices, and worse-than-expected inflation all have combined to send interest rates higher, particularly in order to establish returns that would be satisfactory to foreign investors. Dollar weakness, higher inflation and higher interest rates have occurred almost simultaneously, the major surprise of the year (Chart 1).

So far this year, the principal inflation indices—the CPI-U, the Producers' Price Index (PPI) and the implicit GNP deflator—all have shown substantial rises, ranging from 3.5% to over 8%, the monthly figures at annual rates (Table 6). A lower dollar and higher oil and energy prices are most responsible for the increased pace of inflation, with rises in services prices also contributing. A classic demand-pull inflation has not been present, except to some extent in services. Unit labor costs, especially in manufacturing, have been rising slowly or occasionally declining.

The onset of so much worse inflation is one of the surprises this year. Is the inflation genie out of the bottle? Probably, yes. The higher pace of inflation is unlikely to fade quickly. Inflation typically is a serially correlated process that does not quickly spike down after showing an acceleration. Once initiated, higher inflation from any source can reverberate through the economy, impacting on decisions and expectations, then other prices of goods and services, into wages, and eventually unit labor costs.

Chart 1
The Dollar, Inflation, and Long-Term Interest Rates



Sources: Morgan Guaranty Trust Company, Bureau of Labor Statistics, Federal Reserve Board

Mitigating against a 1970s-like inflation experience are generally slack economies worldwide and low rates of wage increases in the United States, where competition in labor markets, especially goods-producing, remains intense. But more pro-growth macroeconomic policies overseas, increasing pressure in the industrial side and a catchup of wage costs promise growing inflationary pressure, on average, in coming years.

Whether, how much, and for how long the inflationary process generates higher inflation rates is more unclear this time around because of the dollar-related nature of its inception. Once the dollar impulse for inflation ends, some other source

Table 6
Inflation and Its Determinants:
Recent Evidence

	May 1987	Apr. 1987	Mar. 1987	Feb. 1987	Jan. 1987	Dec. 1986	Nov. 1986	Oct. 1986	Sept. 1986
Consumer Price Indices:									
All Urban, Percent Change	0.3	0.4	0.4	0.4	0.7	0.2	0.2	0.2	0.3
Percent Change, Year Ago	3.9	3.8	3.0	2.2	1.5	1.2	1.3	1.6	1.8
Commodities, Percent Change	0.4	0.5	0.5	0.5	1.0	0.1	0.1	0.0	0.4
Percent Change, Year Ago	3.6	3.6	1.9	0.2	-1.2	-1.9	-1.8	-1.5	-1.3
Services, Percent Change	0.3	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.2
Percent Change, Year Ago	4.2	4.0	4.2	4.3	4.3	4.4	4.5	4.8	4.9
Producer Price Indices:									
Finished Goods, Percent Change	0.3	0.7	0.4	0.1	0.4	0.1	0.0	0.3	0.3
Percent Change, Year Ago	2.6	2.7	1.5	0.1	-1.4	-2.2	-1.8	-1.3	-0.9
Intermediate Goods, Percent Change	0.5	0.3	0.3	0.5	1.0	0.0	0.0	-0.3	0.4
Percent Change, Year Ago	2.0	1.3	0.0	-1.5	-3.2	-4.3	-4.1	-3.9	-3.6
Crude Goods, Percent Change	3.1	2.8	0.1	1.8	2.1	-0.9	-0.7	1.5	-0.1
Percent Change, Year Ago	9.2	8.2	2.4	0.0	-5.5	-8.9	-8.4	-6.6	-5.5
Other Inflation Indicators:									
Prices Paid to Farmers (NSA)									
Percent Change	3.2	1.6	0.8	0.8	0.0	-2.4	2.5	-0.8	-2.4
Percent Change, Year Ago	4.9	3.3	0.8	0.0	-2.4	-5.5	-2.4	-1.6	0.8
Spot Oil Prices, Brent Crude									
Percent Change	2.9	0.4	4.7	-6.2	14.5	9.4	5.3	-1.5	2.3
Percent Change, Year Ago	34.7	46.7	32.0	1.2	-15.2	-39.1	-50.9	-51.3	-49.0
Raw Industrial Commodities									
Percent Change	6.3	3.0	-0.4	-2.2	2.1	1.6	3.5	6.5	4.3
Percent Change, Year Ago	21.9	15.4	10.4	0.6	6.7	5.3	3.9	-0.6	-7.1
CRB Spot Price Index									
Percent Change	6.4	2.7	0.3	-1.7	0.9	0.3	2.1	4.4	1.6
Percent Change, Year Ago	14.9	8.9	4.3	-0.7	-1.3	-2.7	-2.5	-3.1	-7.4
Hourly Earnings Index									
Percent Change	0.1	0.2	0.2	0.4	0.1	-0.1	0.6	0.2	0.2
Percent Change, Year Ago	2.2	2.4	2.2	2.1	2.2	2.0	2.6	2.4	2.0
Key Monthly Economic Indicators:									
Unemployment Rate, Civilian (%)	6.3	6.3	6.6	6.7	6.7	6.7	6.9	6.9	7.0
Capacity Utilization, Total (%)	79.6	79.4	79.6	79.7	79.4	79.6	79.3	79.0	79.0
Capacity Utilization, Mfg. (%)	80.2	79.9	80.2	80.3	79.9	80.0	79.7	79.6	79.6
Vendor Performance	60.0	57.0	55.0	52.0	55.0	56.5	55.5	54.0	51.5
Dollar, Trade Weighted									
Exchange Rate, Percent Change	-0.3	-2.2	-0.9	-1.6	-3.9	-0.9	1.2	0.0	-0.1
Percent Change, Year Ago	-11.6	-13.0	-12.0	-12.8	-14.5	-11.8	-11.6	-14.1	-18.4

Table 6 (Continued)
Inflation and Its Determinants:
Recent Evidence

	87:1	86:4	86:3	86:2	86:1	85:4	85:3	85:2	85:1
Key Quarterly Economic Indicators:									
Unit Labor Costs, Nonfarm Business									
Percent Change, SAAR	-0.5	4.2	2.6	1.8	-1.2	3.5	7.4	1.0	3.6
Percent Change, Year Ago	2.0	1.8	2.6	2.2	2.5	3.7	3.0	4.0	3.4
Nonfarm Productivity Growth									
Percent Change, SAAR	0.5	-1.5	0.0	0.5	4.3	-3.5	2.2	1.8	0.3
Percent Change, Year Ago	-0.2	0.7	0.2	0.8	1.2	0.2	1.0	0.2	0.8
Manufacturing Productivity Growth									
Percent Change, SAAR	2.1	0.2	4.3	4.3	4.0	-0.3	4.4	8.2	3.9
Percent Change, Year Ago	2.7	3.2	3.3	3.2	4.4	4.0	4.4	5.2	4.0
Full Employment GNP Gap (Billions of 1982 Dollars)	113.0	132.0	121.4	126.7	112.7	126.2	123.9	138.4	136.8
"Gap" to Full Employment GNP (%)	2.9	3.4	3.2	3.3	3.0	3.4	3.3	3.7	3.7

must pick up the baton. This does not have to occur. But the history of the inflation process suggests an upward trend unless there is some intervention to stop it.

On current prospects, a 4-1/2% to 5% rate of inflation can be expected in the major indices, measured on a fourth quarter-over-fourth quarter basis. Quarterly inflation rates, expressed at annual rates, are projected to run between 4% to 6% over much of this year. On average, the forecast shows a rising trend for inflation until 1989, when a significant slowdown in the U.S. economy starts to bring a reduction.

There are two possible tracks for inflation. One is the possibility that the surge of inflation off the lower dollar will be a one-shot affair, with a one-time increase in the price level and the inflation rate receding over the next year. The second possibility is that inflation will proceed as it has in history, with the initial impulse, this time, from a lower dollar and higher oil and energy prices, spreading through the economy and into expectations to sustain the current higher inflation rates and perhaps moving them even higher. Which track is taken will be a decisive factor for the performance of the economy.

The higher inflation is the fundamental cause of higher interest rates so far this year, and, if sustained, sets a floor on any declines for interest rates. Every business expansion has eventually been brought to a halt by some combination of higher inflation and higher interest rates.

Employment and Unemployment—Tighter Labor Markets, Especially in Services

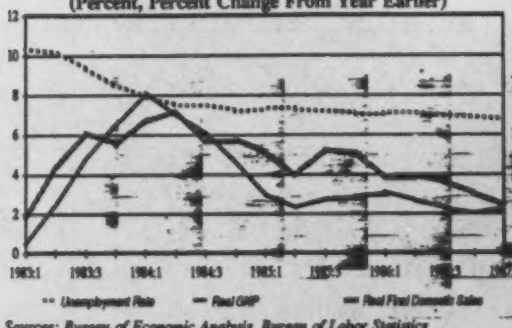
Another big change since the beginning of the year has been a substantial improvement in the unemployment rate, down surprisingly, to 6.3% in May from 7% just last September. The 0.7 percentage point drop in the unemployment rate at the same time real economic growth has been rising so slowly (at a 2% to 2-1/2% average rate) is unusual (Chart 2). Normally, a near 5% growth rate would have been required over the past year to produce the 0.7 percentage point decline that has occurred in the unemployment rate, assuming that potential real GNP has been growing at a 2-1/2% rate.

With the surprisingly low unemployment rate has come a continuing series of large rises in nonfarm payroll employment, led by increases in services jobs, the source of most growth in employment since the beginning of the expansion.

What accounts for the strong growth in jobs and low unemployment rate?

Jobs growth, especially with the weakness in manufacturing over the past two years, has been extraordinary. Over the past year, the labor force has increased by a large 2.4 million persons, services sectors employment is up a huge 2.3 million and goods-producing sectors employment has risen by only 39,000.

Chart 2
Unemployment Rate, Real GNP, and Real Final Domestic Demand (Percent, Percent Change From Year Earlier)



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics

Most likely, as jobs were lost in goods-sector production, services-sector employment picked up more than the jobs lost as workers took on extra positions to generate income lost in the higher-paying goods employment. More Americans are working more hours and more jobs now, probably to sustain income and the previous standards of living. With [illegible] lower marginal tax rates, greater incentives to work effort exist in many cases.

The low unemployment rate may well reflect weak growth in potential real GNP. Given the shift to a services economy from a goods economy, the lower productivity growth in services sectors would tend to reduce the growth of potential real GNP. Actual growth in excess of potential can occur at lower figures, perhaps the 2-1/2% or so of growth over the past year. Less potential growth for the economy could be part of the current situation of a relatively low unemployment rate. This could also mean more inflationary pressure than might otherwise have been thought.

Business Profits—Very Strong So Far, The Issue is Momentum

Business profits have been very strong so far this year. For aftertax corporate profits, the first quarter showed a rise of 9.4% over a year ago. The S&P500 earnings per share showed a huge 17% year-over-year increase. Cost-cutting, increased sales, earnings translation effects from a lower dollar, and rises off a low base all account for the surge in profits. The economy thus has delivered the profits growth that the stock market had discounted in its sharp rise early this year. The earnings growth has been particularly impressive considering the $20 billion to $25 billion tax increase on business from the Tax Reform Act of 1986. A 20% to 30% increase is projected for S&P500 earnings per share in 1987. Higher profits and improved cash flow should provide a good base for increased capital spending by U.S. businesses next year.

The major issue for profits is one of momentum—can the [illegible]ed-up pace of profits growth be sustained? The answer here lies in whether [illegible] business expansion, U.S. and worldwide, can continue much beyond 1988. Growth in profits is expected to be reasonably robust for the rest of the year, but much weaker in 1988, up 13%, reflecting the maturing business expansion, increasing pressure on capacity, higher costs of doing business, and no further major gains to earnings from a lower dollar.

The "Twin Deficits"—The Big Risk

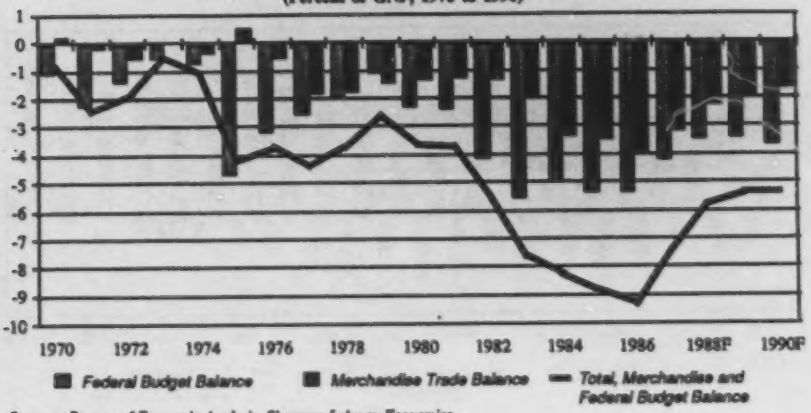
The major problem for the U.S. economy remains the "twin deficits"—budget and trade—which promise little improvement and provide a fundamental source of downward pressure on the dollar, upside risks on inflation, and possibly higher interest rates.

The problem of the twin deficits is the associated debt and interest charges on the debt over time, which can claim an ever-increasing share of GNP and require higher interest rates to attract financing, either from abroad or in the United States. At some point, the large deficits and debt must be associated with high enough interest rates to induce saving and to reduce spending. If the deficits were to decline or disappear, then this risk would be removed.

The burden of the deficits relative to GNP eventually can be quite considerable (Charts 3, 4, 5), with public debt increasing even at lower budget deficits and net foreign debt eventually generating significant interest charges to be paid along with those on the outstanding U.S. government debt.

The net debtor position of the U.S. is rapidly increasing, having reached $263.5 billion in 1986 from $111.6 billion in 1985. Although the size of the U.S. net debt position may be overstated because of

Chart 3
Federal Budget Balance Plus Merchandise Trade Balance
(Percent of GNP, 1970 to 1990)



Sources: Bureau of Economic Analysis, Shearson Lehman Economics

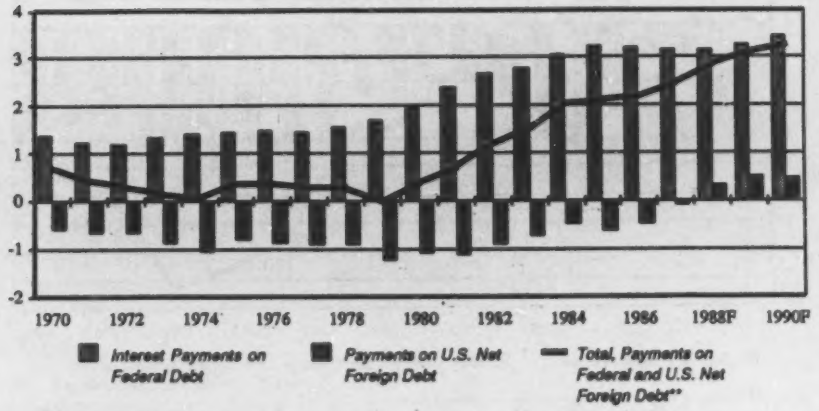
Chart 4
Federal Debt Plus U.S. Net Foreign Debt*
(Percent of GNP, 1970 to 1990)

* *U.S. net foreign debt equals U.S. assets abroad minus foreign assets in the U.S.*

** *To avoid double-counting, Federal debt held by foreigners is deducted from Federal debt.*

Sources: Bureau of Economic Analysis, U.S. Treasury Department, Shearson Lehman Economics

Chart 5
Payments on Federal Debt and on U.S. Net Foreign Debt*
(Percent of GNP, 1970 to 1990)



* *Payments on U.S. net foreign debt equal payments on foreign assets in the U.S. minus receipts from U.S. assets abroad.*

** *To avoid double-counting, interest payments on Federal debt held by foreigners are deducted from net interest payments on Federal debt.*

Sources: Bureau of Economic Analysis, U.S. Treasury Department, Shearson Lehman Economics

capital gains on foreign holdings of U.S. securities and book valuation of U.S. assets, the deteriorating net investment position of the United States represents a clearcut trend, not to be reversed until at least the 1990s when surpluses in the U.S. trade deficit might occur.

Shearson Lehman estimates show a $775 billion net debtor position for the U.S. by 1990, with $725 billion the net deficit position for securities upon which interest payments must be made. At an interest rate of 7% to 8%, the interest payments would be about $45 billion to $50 billion. When added to the estimated $185 billion of interest payments on outstanding federal government debt, the payments on debt will constitute a considerable claim against the flow of GNP in the U.S. economy.

To reverse this trend requires the federal budget or trade deficit, or both, to decline in coming years. On current prospects, such declines are not very likely.

So far this year, both deficits, budget and trade, show no signs of a significant and permanent improvement; indeed, prospects for the budget deficits now appear worse than might have been expected before.

The major source of the twin deficits, the federal budget, seems to have reached an impasse in terms of further declines (Table 7).

For fiscal 1987, the SLB estimate for the unified budget deficit is $182.5 billion. But this includes a one-shot rise in capital gains tax receipts of $10 billion to $15 billion or as high as $30 billion, due to the change in capital gains taxes from the Tax Reform Act of 1986. Thus, in a more permanent sense, the FY1987 budget deficit is in the $190 billion to $200 billion range.

For fiscal 1988, a $37 billion deficit reduction plan has been passed in a Joint Resolution of Congress, to make its way through the rest of the budget process. With slippage allowed in the reconciliation

process, the $37 billion deficit reduction plan is likely to translate into bona fide reductions of $30 billion to $32 billion. This range was the SLB expectation in a $171.5 billion estimate for the deficit in FY1988. However, $19.3 billion of deficit reduction is in the form of a tax increase that the President will not accept. If he does not, $7 billion of defense spending will be lost to him. The net result could be a deficit in the $180 billion range.

For fiscal 1989, assuming a major slowdown in the U.S. economy and another $40 billion of bona fide deficit reduction items, the budget deficit would be near $176 billion or even higher.

Table 7
U.S. Federal Budget Deficits and Debt—
History and Forecasts (1985 to 1990)
(Billions of Dollars, Fiscal Years, Unless Otherwise Indicated)

	1985	1986	1987	1988	1989	1990
Budget						
Receipts	734.1	769.1	840.0	898.0	967.0	1,038.3
Outlays	946.3	989.8	1,022.5	1,069.8	1,142.5	1,231.1
Nondefense	693.6	716.4	740.5	784.8	852.5	931.1
Defense	252.7	273.4	282.0	285.0	290.0	300.0
Unified Budget Deficit	212.3	220.7	182.5	171.8	175.5	192.8
Percent of GNP	5.4	5.3	4.2	3.7	3.5	3.6
Structural Budget Deficit	162.0	187.1	158.6	144.3	145.5	150.4
Percent of GNP	4.1	4.5	3.6	3.1	2.9	2.8
Current Services Budget						
Receipts	734.1	769.1	840.0	883.0	952.0	1,023.3
Outlays	946.3	989.8	1,022.5	1,093.0	1,157.0	1,225.3
Nondefense	693.6	716.4	740.5	803.0	852.0	903.3
Defense	252.7	273.4	282.0	290.0	305.0	322.0
Unified Budget Deficit	212.3	220.7	182.5	210.0	205.0	202.2
Percent of GNP	5.4	5.3	4.2	4.5	4.1	3.8
Structural Budget Deficit	162.0	187.1	158.6	190.0	185.0	163.0
Percent of GNP	4.1	4.5	3.6	4.1	3.7	3.1
Treasury Financing						
Total Treasury Financing	197.3	236.2	183.5	172.8	176.5	193.8
Debt Held by the Public (End of Year)	1,509.9	1,746.1	1,929.6	2,102.4	2,278.9	2,472.7
Percent of GNP	38.3	41.9	44.2	45.0	45.3	46.8
Net Interest Cost	129.1	135.3	141.0	155.0	160.5	185.0
Percent of GNP	3.3	3.2	3.2	3.3	3.2	3.5
Economic Assumptions (Calendar Years, Except Where Noted)						
Real GNP (% Chg., 4th Qtr./4th Qtr.)	2.9	2.2	3.0	3.2	1.5	0.5
GNP Deflator (% Chg., 4th Qtr./4th Qtr.)	3.3	2.1	4.6	3.7	5.5	4.0
Real GNP (% Chg.)	2.7	2.5	2.5	3.1	0.9	0.8
GNP Deflator (% Chg.)	3.3	2.6	3.5	4.1	4.7	4.1
Unemployment Rate (%)	7.2	7.0	6.4	5.9	6.3	6.8
91-Day Treasury Bill Rate (%)	7.5	6.0	5.7	6.7	7.5	6.8
10-Year Treasury Note Yield (%)	10.6	7.7	8.2	9.1	9.4	8.4

Thus, the budget prospects now suggest a plateauing of deficits in the $175 billion to $200 billion range, worse than previous market expectations of gradual declines to much lower levels, although expectations never included achievement of the Gramm-Rudman-Hollings (GRH) targets. Any further break in the federal budget deficit gridlock thus may await the next Administration.

The other half of the twin deficits, the trade balance, is only improving slowly (Charts 6, 7).

Although clearly lower in inflation-adjusted terms, the merchandise trade deficit, in the widely watched nominal basis, has not yet shown a clear upturn. The worst does seem to be over, with the pattern of merchandise trade, with or without oil, following an "L," "U," or possibly a "J" configuration (Charts 6,7). The improvement forecast is near $25 billion for the year, one of the more optimistic projections on merchandise trade. This positive swing is worth about one percentage point of expected growth over this year.

However, even with this kind of improvement, the merchandise trade deficit that will occur in 1987 is estimated at $143.5 billion; in 1988, $111 billion. These large deficits are a long way from balance.

Why is a more quick and greater turn in trade not likely?

There are four reasons. First, although the dollar has dropped sharply against some currencies, it has not fallen much against several and has risen against some others. The dollar has declined sharply only against the currencies of Japan, Germany, the United Kingdom, Italy and France, which together account for a little more than half of the U.S. merchandise trade deficit. With nearly half the deficit accounted for by countries against whose currencies the dollar fluctuates little or has actually strengthened, there is not much leverage on turning the deficit from a lower dollar. Second, relative prices of import goods vs. domestic goods have not changed that much, having been met in many instances by price hikes in the competing American industries. With relative prices just beginning to show wide differentials in some cases, the substitution of domestic goods for foreign goods necessary for a major turn in trade has probably only just begun. Third, slow growth overseas hampers U.S. exports, but even if faster growth were to occur, not enough of U.S. exports are bought by key countries such as Japan and Germany to make much of a difference very quickly. Last year, Germany bought 4.6% of U.S. exports and Japan purchased 11.5%. Additional growth in these countries cannot directly help U.S. trade very much; neither can the indirect effects of faster growth in Japan and Germany make that much difference over a relatively short time-span. Finally, the global economy is more competitive, with many entrants now for many products, never before the case in the world marketplace.

Given the political gridlock on the U.S. federal budget deficit and so many structural impediments to trade, prospects for the twin deficits are grim, indeed.

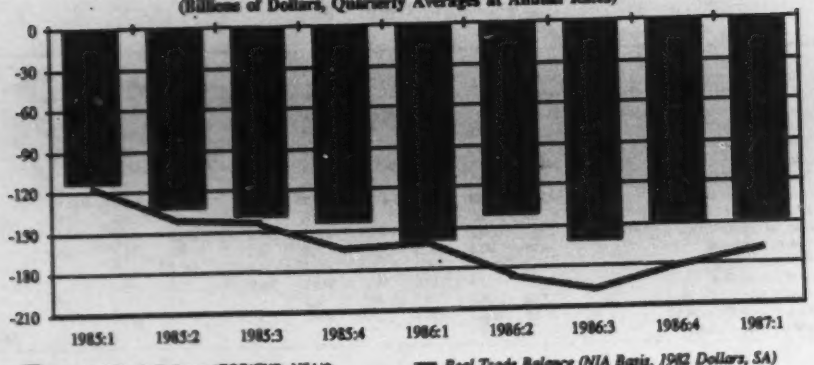
Most likely, the high federal budget deficits will continue, at least until the next Presidential election, and, along with an ever-increasing net debtor position for the U.S., will saddle the world with a huge amount of dollar-denominated debt and the U.S. with very large interest payments on the outstanding debt. In turn, with the dollar the international reserve currency, the absorption of so much dollar-denominated debt likely will require higher U.S. interest rates than otherwise would occur.

Risks

The budget and trade deficits remain the biggest risk to sustained expansion in the U.S., suggesting downside potential for the dollar, upside risks on inflation and interest rates, and a downside possibility on real economic growth. Already, the financial markets have provided a taste of the interest rate spikes and shakiness in equity markets of the deficits-debt-dollar-inflation-interest rates risk. There is only one way out, the easing off or purposeful removal of such large deficits.

One risk monitored by SLB is the difficulties surrounding the dollar (Table 8). The catalyst for the downside risk on the economy would be little improvement in foreign trade in coming months, with imports continuing to rise and exports up, but not very much. Only modest improvements in the trade and current account deficit eventually could drive the dollar lower, perhaps at a time of heavy Treasury financing, conceivably later this summer when the Treasury has a major end-of-quarter refunding. Further declines in the dollar would tend to raise inflation and inflation expectations, in turn driving interest rates sharply higher. In May, the spike-up on long-term interest rates prior to the Treasury

Chart 6
Nominal and Real Merchandise Trade Balance
(Billions of Dollars, Quarterly Averages at Annual Rates)



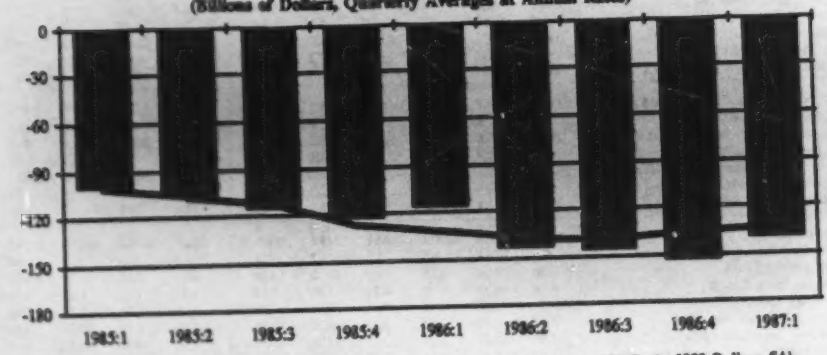
*Nominal Trade Balance (FOB/CVB, NSA)**

Real Trade Balance (NIA Basis, 1982 Dollars, SA)

** FOB = Free on Board; CVB = Customs Value Basis.*

Source: Bureau of the Census, Bureau of Economic Analysis

Chart 7
Nominal and Real Merchandise Trade Balance: Manufactured Goods*
(Billions of Dollars, Quarterly Averages at Annual Rates)



*Nominal Trade Balance (FOB/CVB, NSA)***

Real Trade Balance (NIA Basis, 1982 Dollars, SA)

** Exports are non-agricultural; Imports are non-petroleum.*

*** FOB = Free on Board; CVB = Customs Value Basis.*

Source: Bureau of the Census, Bureau of Economic Analysis

Table 8
Shearson Lehman "Alternative" Forecast of the U.S. Economy and Financial Markets
June 22, 1987
(Probability=0.25)
"Stagnation"

	Quarters						Years			
	1986:4	1987:1	1987:2	1987:3	1987:4	1988:1	1986	1987	1988	1989
Gross National Product-1982 Dollars	3696.1	3739.5	3741.9	3742.5	3729.6	3712.5	3675.0	3738.4	3725.6	3798.9
Annual Rate of Change	1.1	4.8	0.3	0.1	-1.4	-1.8	2.5	1.7	-0.3	2.0
Percent Change Year Ago	2.0	2.3	2.2	1.5	0.9	-0.7	2.0	0.9	0.6	3.0
Consumption	2445.8	2438.8	2448.2	2451.8	2458.2	2460.0	2418.7	2449.3	2465.1	2499.4
Annual Rate of Change	-0.4	-1.1	1.6	0.6	1.0	0.3	4.1	1.3	0.6	1.4
Business Fixed Investment	457.8	446.3	449.2	443.2	435.7	427.7	456.7	443.6	428.6	447.6
Annual Rate of Change	3.0	-9.7	2.6	-5.2	-6.6	-7.1	-1.0	-2.9	-3.4	4.4
Residential Construction	199.7	197.3	193.6	190.3	186.5	187.0	194.0	191.9	184.4	186.0
Inventory Investment	-28.5	40.7	21.5	17.0	9.7	5.8	6.6	22.2	4.0	3.7
Net Exports	-148.0	-133.7	-130.2	-125.4	-130.5	-139.2	-147.8	-130.0	-126.7	-119.4
Federal Government	348.6	325.3	332.0	340.7	345.8	346.9	332.2	336.0	342.0	339.8
Annual Rate of Change	23.2	-24.2	8.5	10.9	6.1	1.3	2.7	1.1	1.8	-0.6
State and Local Government	420.7	424.8	427.6	424.9	424.2	424.1	414.6	425.4	428.3	441.8
Annual Rate of Change	1.1	4.0	2.7	-2.5	-0.7	-0.1	4.3	2.6	0.7	3.2
Industrial Production (1977=1.000)	1.259	1.268	1.268	1.269	1.260	1.245	1.251	1.266	1.236	1.264
Annual Rate of Change	2.9	2.9	0.0	0.3	-2.8	-4.7	1.0	1.2	-2.4	2.2
Housing Starts (Mil. Units)	1.701	1.795	1.605	1.480	1.391	1.481	1.819	1.568	1.521	1.609
Auto Sales-Total (Mil. Units)	11.5	9.8	8.7	9.0	8.0	8.2	11.6	8.9	9.8	10.4
Unemployment Rate-Civilian (%)	6.8	6.7	6.3	6.5	6.7	6.9	7.0	6.5	7.6	7.6
Federal Budget Surplus										
Unified (Quarterly Rate, NSA, FY)	-64.4	-58.6	-28.7	-58.9	-81.6	-77.7	-220.7	-210.5	-251.9	-241.5
Implicit Price Deflator (%CH)	0.7	4.2	5.3	5.8	5.5	5.7	2.6	3.8	4.7	3.4
CPI- All Urban (%CH)	2.7	5.3	6.2	6.5	5.7	6.5	1.9	4.4	5.1	3.6
PPI-Finished Goods (%CH)	2.5	3.2	5.9	6.1	6.7	6.4	-1.4	3.2	5.2	2.7
Hourly Earnings (%CH)	2.9	2.0	2.2	2.0	3.1	3.6	2.4	2.2	2.8	2.1
Trade-Weighted Exchange Rate	1.027	0.971	0.937	0.870	0.802	0.789	1.060	0.895	0.820	0.852
Annual Rate of Change	-0.3	-20.1	-13.3	-25.7	-27.8	-6.3	-16.7	-15.6	-8.4	3.9
Merchandise Trade Balance (Bils. $'s)	-171.5	-168.9	-158.2	-150.5	-153.4	-154.0	-166.3	-157.8	-139.5	-115.7
Corporate Profits Aftertax (Bils. $'s)	144.5	135.8	138.1	140.9	139.6	136.6	134.0	138.6	132.3	137.1
Percent Change Year Ago	3.7	7.0	7.2	3.7	-3.4	0.6	2.0	3.4	-4.5	3.6
Adjusted Profits Aftertax (Bils. $'s)	196.1	203.6	203.1	206.4	205.2	201.9	197.1	204.6	205.9	207.3
Percent Change Year Ago	3.6	1.4	4.8	4.5	4.6	-0.8	4.4	3.8	0.7	0.6
Real Disposable Income (Bils. $'s)	2596.6	2612.1	2579.9	2602.5	2617.1	2626.3	2602.3	2602.9	2668.3	2738.3
Annual Rate of Change	-1.4	2.4	-4.8	3.6	2.3	1.4	2.9	0.0	2.5	2.6
Personal Saving Rate (%)	2.6	2.8	2.5	3.2	3.1	3.5	3.9	2.9	3.9	5.2
M2 (Bils. $'s)	2778.6	2822.5	2820.1	2841.1	2873.6	2890.3	2778.6	2873.6	3023.0	3220.0
Annual Rate of Change	9.5	6.5	-0.3	3.0	4.7	2.3	8.9	3.4	5.2	6.5
Prime Rate (%)	7.50	7.50	8.15	9.08	10.00	10.50	8.33	8.68	10.12	8.65
Federal Funds Rate (%)	6.27	6.22	6.85	8.11	9.08	8.84	6.81	7.57	8.22	6.70
3-Month Treasury Bill (%)	5.35	5.54	5.84	7.08	7.97	7.79	5.98	6.61	7.45	6.30
10-Year Treasury Note (%)	7.26	7.19	8.43	9.97	10.78	10.57	7.68	9.09	10.17	8.24
30-Year Treasury Bond (%)	7.53	7.49	8.68	10.21	11.04	10.77	7.80	9.36	10.37	8.46
New AAA-Equiv. Corporate Bon. . (%)	8.43	8.13	9.75	11.27	12.10	11.77	8.62	10.31	11.31	9.11
Bond Buyer Index (%)	6.93	6.63	7.91	9.32	10.02	9.61	7.32	8.47	9.67	8.36
S&P 500 Index of Common Stocks	242.97	279.31	283.73	270.88	248.95	241.45	236.17	270.72	271.58	269.93
Annual Rate of Change	3.1	74.6	6.5	-16.9	-28.7	-11.5	24.6	14.6	0.3	-0.6
Earnings Per Share - S&P 500 ($)	2.96	4.47	3.91	4.38	4.36	4.33	14.48	17.12	16.33	16.22
Percent Change Year Ago	-11.1	17.0	2.4	12.9	47.3	-3.1	-0.9	18.2	-4.6	-0.7
Price-Earnings Ratio - S&P 500	16.8	18.5	18.6	17.2	14.5	14.2	16.3	17.2	16.3	16.7

Forecast Assumptions
"Pessimistic" Case
U.S. Economy and Financial Markets
"Stagnation"

1. Little improvement in foreign trade for the U.S., with imports continuing to rise and exports not very much changed.
2. The dollar drops sharply lower, down almost 15% by early next year.
3. Inflation gets much worse, into the 6% to 7% range, on a quarterly average basis.
4. Interest rates rise sharply, from a much lower dollar, higher inflation, and several increases in the discount rate.
5. The stock market falls sharply, with the Dow-Jones down to around 1,850.
6. Consumer spending fades with weak real income, higher interest rates, and stock market declines, cutting back on autos and other spending.
7. After-tax corporate profits drop through the next year.
8. As a result, the U.S. industrial sector remains weak and business capital spending keeps declining. Tax reform is a further depressant on this area.
9. There is new fallout on manufacturing, mining and agriculture. Failures pick up.
10. The rest-of-the-world also suffers a downturn, further depressing the U.S. economy.
11. The Federal budget deficit worsens and is much higher than in the Baseline.
12. The unemployment rate moves sharply higher, almost reaching 8% in late 1988.
13. The negative patterns in the economy continue well into 1988, before beginning to reverse.
14. Inflation and interest rates begin to drop in late 1988, extending into 1989, which is still a year of weak growth.

financing was 1.1 percentage points as foreign investors held back on commitments until interest rates rose considerably.

In such a situation, the stock market would fall sharply. Consumer spending would likely fade in the face of weak real income, the higher interest rates, and the stock market declines. The weaker dollar and higher inflation would require tighter monetary policy, in turn hurting the economy more. Appreciating currencies in Japan and Germany would tend to weaken the economies in the rest-of-the-world. The end result would be all economies sinking together, slowly receding into a recession.

Odds on such a scenario are approximately 1-in-4, leaving a 1-in-10 shot at a better performance than in the baseline SLB forecast.

U.S. Monetary and Fiscal Policy—In a Dilemma

The current twin deficits problem hamstrings U.S. monetary and fiscal policy.

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For the Federal Reserve, potential additional weakness in the dollar and/or higher inflation suggest higher interest rates than otherwise would be the case, despite the risk to the economy. With inflation running at 4% to 5%—high rates compared to past experience other than in the 1970s—the central bank could follow a tighter monetary policy. But the risk of such a policy probably is too great for the current membership of the Federal Reserve, which is very concerned about U.S. and worldwide recession. The central bank finds itself essentially in the same dilemma as virtually every other central bank at similar times in past U.S. business expansions, unable or unwilling to tighten monetary policy in the early stages of an inflation; instead, choosing to wait until the inflation fades away. In previous episodes, this hope has been a pipedream.

For fiscal policy, the dilemma is a future one. How will fiscal policy be used in the next recession when deficits are already so high? Fiscal stimulus as a means out of the next U.S. recession seems unlikely in a situation of near $200 billion deficits. Any kind of slowdown in the U.S. economy will mean much higher deficits. Higher deficits, in turn, tend to prop interest rates, keeping the deficits high given that interest outlays are the third largest category of federal government expenditures. With deficits rising and any kind of slowdown, fiscal stimulus will hardly be possible. The imbalances of the past may well insure a difficult downturn, when and if one occurs.

Conclusion—Policy the Key to Sustained Expansion

Business expansions do not last forever. Sooner or later, some sort of a downturn must occur.

For the U.S. economy, the processes that lead to a recession do seem to have begun ticking away; principally, a reacceleration of inflation, tightening labor markets, diminishing slack in the industrial sector, and rising interest rates. The issue is when, not whether, a recession will occur, unless some new magic formula is discovered that permits Washington, Bonn and Tokyo to make the right policy choices at the right time through the end of the decade.

Unfortunately, achieving the necessary combination of policies to sustain the expansion is not a simple, straightforward matter. Several years ago, a "simple" way out existed through large reductions in the budget deficit when the U.S. economy was growing strongly. Time passed and not enough was done. A year-and-a-half ago, a much tighter budget accompanied by substantially easier monetary policy might have done the trick, although the timing in such a twist of the policy mix would not have been easy. Now, much of the same medicine as before is required, but the rest-of-the-world, especially Japan and Germany, are involved and simultaneous changes of policies must occur there as well to offset any budget restraint.

The starting point for policy to sustain the expansion lies in much bigger budget deficit reductions than Congress and the President are now contemplating. Another gridlock on the budget exists, with agreement on the current deficit reduction plan of $37 billion appearing remote, and even that plan insufficient to remove the risks of trouble later. Some $50 billion and more of deficit reduction, using a combination of spending reductions in nondefense and defense and tax increases that do not involve marginal tax rates, seems appropriate. An offsetting ease of monetary policy would be necessary to prevent the restraint of such a budget tightening from pushing the economy into a recession. Even more is necessary, however, in this instance a decided shift from fiscal restraint and high real interest rates in Japan and Germany toward budget ease and lower interest rates. Given the imbalances that now exist, only offsetting actions, here and abroad, to any budget tightening can restore the necessary policy balance for currency stability and sustained growth.

Though seemingly difficult, the kind of cooperation and coordination in the United States and across borders and overseas to achieve this result is not beyond the realm of possibility. It may be beyond the realm of political will, however.

Senator SARBANES [presiding]. Thank you very much, Mr. Sinai. Mr. Ratajczak, please proceed.

STATEMENT OF DONALD RATAJCZAK, DIRECTOR, ECONOMIC FORECASTING CENTER, GEORGIA STATE UNIVERSITY

Mr. RATAJCZAK. Thank you very much. I'm going to try to collapse some of my prepared statement.

This year began actually with two offsetting events. The first event was a substantial shift in purchasing patterns as a result of the tax changes. We in fact had a movement of purchasing power into the fourth quarter on automobiles and also on capital goods because of the tax law changes.

This, in turn, increased orders and encouraged the manufacturing sector, which was starting to see a buildup of orders and exports, to build up inventories. They also had one other factor encouraging inventory rebuilding and that was in August of last year industrial material prices started to increase. We had been on a decline in industrial material prices for more than 2 years, but there definitely were signs of increasing, and as short-term interest rates were still declining modestly, this significantly lowered the cost of holding goods in inventory. So we did start to see a little bit of inventory accumulation taking place as the year began. One of my surprises for the year was increased production by the automobile industry. I simply don't understand why they were producing for an 11 million car demand when all of the forecasts said something like 10.2 to 10.3 million, but they did produce for the higher sales levels. The result was an excess supply of automobiles early in the year. It did sharply increase the first quarter's GNP estimate, but clearly that kind of GNP growth is not sustainable and we will see a slowing in GNP when the second quarter results come in.

One other area that hasn't been discussed is the construction industry. It's not a surprise. Again, part of this is tax law changes which significantly reduced incentives to develop construction ahead of demand. We have been developing construction significantly ahead of demand over the past several years. As a result, there now has been a significant slowing, initially hitting the rental properties but now with the latest F.W. Dodge contracts showing an 8 percent decline, drifting over into the nonresidential activities as well.

We expect up to a 9-month lag between the decline in contracts and decline in activity. As a result, we are saying that construction spending for nonresidential activity will remain strong through 1987, but will weaken toward the end of the year and be a definite declining factor in 1988.

The other economic surprise which had an impact upon construction was the increase in interest rates early in the year. As Mr. Sinai has mentioned, most forecasters actually expected interest rates would rise in the second half of the year, but most had anticipated further declines in the first half of the year. The reason I had assumed a decline early in the spring was because we expected that oil prices could not hold at $18 a barrel unless the OPEC nations showed greater resolve in restraining production that they had shown in the past. Well, the OPEC nations have fooled us and

have shown greater resolve and, as a result, oil prices are higher at the present time than we had anticipated.

That led to the higher inflationary pressures than we had expected. That, in turn, after a lag, led to a significant bout of inflationary jitters that hit the commodity markets in April and May and had a decided adverse effect on the financial markets, at least the bond markets. The stock market didn't worry too much about this movement, but the bond markets were a little bit upset and interest rates moved higher. Mortgage rates, which were 8.5 percent in March, are now at 10.5 percent in June. So we did have a significant reversal of interest rates.

That increase in interest rates is now showing its effect upon housing activity. Our current outlook is for single family starts to fall to the vicinity of 1.1 million in 1988. However, the sales levels that came out in May would generate somewhat lower starts than that. I do think there was some shifting of activity in that May figure to accentuate the degree of weakness, but nevertheless, we are talking about a housing market that has definitely peaked and is now declining and will be declining certainly into 1988.

Considering the decline in construction and the excess inventories, what is going to keep us moving forward over the next year? Here, I have to express the same issues that were expressed by the other presenters. The trade sector is definitely improving, and is going to be a significant contributor to economic activity. It has already been a significant contributor to economic activity, although I would point out that at least on the import side, some of that supposed slowing in the volume of imports is the result of oil companies reducing their inventory holdings under the belief that oil prices couldn't go higher or stay at current levels. In April, the last month we have statistics for, we imported 168 million barrels of oil. Under our current consumption and production levels, we probably will need 210 million barrels a month of foreign imported oil to maintain our current energy requirements.

As oil inventories start to build, we will see at least that one component of imports picking up.

So I do think that some of the improvement in the trade accounts was a little bit stronger early on than could be anticipated over the next few months and, of course, now the dollar is rising a little bit so that may slow down some other factors.

I would also mention several reasons why I don't think we're going to get a dramatic reversal in our trade accounts. We will get a positive one, enough to offset the negatives on construction and some slowing that I anticipate in consumer activity, but the rest of the world is not growing that rapidly. There are a few strong growth countries such as Taiwan and Korea, but the bulk of the world is growing in the vicinity of 2.5 percent and some countries, such as Germany, appear to be growing at a lower rate than that.

With such relatively low rates of growth, the world is not able to significantly absorb a dramatic increase in American goods, regardless of the competitive structure of the American industry. We need stronger growth abroad to get our export activity up above a 7 to 8 percent real growth path.

In addition, of course, I believe any restraint of trade flows into the United States will generate some degree of retaliation. If that

does occur, we would not be talking about the dramatic increases in our trade accounts that we all hope will develop and keep us in a relatively healthy economy.

Overall, the factors involved, include: some slowing in consumer activity from the 4.1 percent growth of 1986 to about 2 percent in 1987 and 2.5 percent in 1988, the slowing in housing, consumer capital spending programs are expected to grow only 2 percent after inflation in 1987 as compared to 4.1 percent last year.

I do expect a little further increase in inventory investment in the second half the year after we get our automobile inventories back into balance. As a result, we are talking about 3 percent growth in 1987, not surprisingly different from the other numbers that were talked about.

However, my one concern is that as we turn around inventories from a rigid, tight, liquidating position to an accumulating position, partially as a result of an increase in industrial material prices, and if we do not allow the natural adjustment process of the economy to work, which is that short-term interest rates move upward to reduce the profitability of holding speculative inventories, then in fact we could get more growth for 3 to 6 months, but then will get unbalanced growth with excessive inventory holdings. The result is that we would then set up a condition for a potential economic decline.

I think there is a realistic possibility that this could occur because industrial material prices, while they are moderating under the most recent indices, are still up significantly even from the April and May levels. There is some potential for the beginning of speculative inventory holding.

A word about inflation. I agree with most of the comments that were made. Basically the inflation of the first half was a bit unusual, caused by energy price rebounds and a flareup in meat prices which should be looked at in the long term as healthy. Not that meat prices rising are healthy, but rather that what spawned the increase in meat prices was the feeling by livestock raisers that there was greater profitability in raising animals and, as a result, they withheld some animals from slaughter. This decreased the amount of animals coming to slaughter just as the barbeque season started, so as a result, we had intensifying meat price increases. But clearly we will have more animals available late in the year or early next year. As a result, meat prices should moderate a little later on.

There is one factor, however, that I think needs to bear some commentary. Wages, which unquestionably have been very modest in their rate of increase, I feel—and everything that I've done econometrically suggests—responds with a lag to the inflationary outlook or the inflationary condition. What has been happening is that a lot of the wages for this year really were budgeted based upon the inflation rate of last year, with the result that we have this very low wage base unquestionably holding down and restraining inflation over the second half of this year. Next year we do expect that wage budgets will be fatter in response to the higher inflation rates we've had this year. As a result, we will shift into some wage induced inflationary pressures.

Responding to some of the comments in the letter, some of the favorable outcomes I think could occur is that first of all, something might happen to respond to Latin American markets and as a result our trade balances could improve. That something is not yet apparent as we are still writing down the previous lending that we've given to Latin America. But if we can get stronger growth in our traditional markets abroad this would significantly improve our trade accounts.

In addition, there's a potential, although I think it's a very small potential, of getting greater economic stimulus out of Germany. I do think that Japan is engaging in increased stimulative programs. The problem we now have with Japan is that we are not directly benefiting from the increased domestic demand that is being generated in Japan. It does appear that most of the imports that are coming into Japan are coming from other trading partners, not from the United States. But it does look as if Japan is stimulating its economy.

Germany, however, appears to believe that its current rate of growth, which is less than 2 percent, is appropriate for the country and it is difficult to tell other countries what to do with their own policy.

Nevertheless, it is possible that trade could perform better than we have expected and I think that's one of the positive factors holding out for next year.

The unfavorable potential? I think there are several, some of which haven't been fully talked about. Clearly, I expect that construction will replace energy as the recession industry of 1987 and early 1988. One of the reasons why we haven't had a major recession in this economy and indeed have had this relatively long expansion is because we've had rolling industry recessions. We had a manufacturing recession in 1985. We had an energy recession in 1986 and in the second half of 1987 we're going to have a construction recession.

Indeed, if we continue to find independent candidates for this, we could probably pursue a 2.5 to 3 percent overall rate of growth for some time to come. However, the people in those industries are going to be a little bit upset about the type of economy that's being generated.

Nevertheless, the construction recession is starting to develop. It did develop slowly at first, but it is intensifying at the present time. As I said, with about a 9-month lag, we will see significant declines in nonresidential construction activity. We are already seeing significant declines in housing activity.

This decline in construction, however, could have longer and more difficult impacts than other declines. To the extent that it is heavily financed, construction values are important in the portfolios of a lot of financial institutions. If those values decline significantly, and they have already declined to some extent, we could have further weakness in our financial structure. I would say that that is our primary problem facing us. The financial sector clearly is not as strong as we would like it to be at the present time. It has already handled energy and foreign loans and it looks like it has some construction loan problems to deal with. We already have

some difficulties with the FSLIC and there is some potential for problems developing there.

I do think that we're on top of these issues and the problems are not going to develop as significantly as they otherwise would.

Now I'd like to end by discussing my policy suggestions. I agree with the other economists that we do need to reduce our government deficits. I think we need to reduce these partially because I am a bit disturbed that we are a debtor nation, not that debt itself is a negative device, it matters how you use debt. But indeed, all the evidence shows that what really has happened is that because of the Government deficits, domestic savings have declined and it's been the foreign capital flows that have made up for this weakness in domestic savings. There hasn't been any enhancement of our investment activity taking place. If we had enhanced investment activity, that would be positive and mean that we would have positive effects to repay that deficit.

Because we do have this savings-investment imbalance, we need to reduce that deficit, reduce the claims that the Government is placing upon the savings pool. So I very definitely think that deficit reduction is in order.

Any revenue-raising programs that may be necessary to lower government borrowings should be more designed to reduce consumption rather than slow production. Concerns about increasing tax burdens for the needy can always be addressed by increasing a low income tax credit in the income tax codes.

I think when people look at these things, and look at one individual tax system, it is true you get to the problem of regressive versus progressive. It certainly is not difficult by working through two or three different tax instruments to get both a deficit reduction program, a reduction program in consumer orientation, and one that is not regressive in nature.

Some trade legislation may be desirable to provide the executive branch with bargaining tools in order to negotiate increased access to foreign markets. Legislation that protects American industry from more efficient production abroad should be avoided. Any quotas that may temporarily be negotiated should be executed by some sale of import licenses so that the U.S. Treasury and not our competitors' corporate treasuries receive gains from access to our markets under such conditions.

At the present time, if we establish a quota, what it means is that the people who have access to the American markets get undue profits and, therefore, create the next series of products to hit us over the head with.

The Federal Reserve should, after considering the health of the financial system as its No. 1 priority, place restraint of inflation as its No. 2 priority. I do not agree with some of the discussion that the Federal Reserve is responsible at the present time for providing significant economic expansion. I really think that monetary policy is not a good instrument for stimulating real economic activity, and that the primary concern of the Federal Reserve should be in controlling inflation. And when inflation becomes excessive, as it did early this year, it may be necessary for them to act in an appropriate manner to reduce the speculative concerns.

Well, I'll end my comments there and I appreciate being asked to provide my views.

[The prepared statement of Mr. Ratajczak follows:]

PREPARED STATEMENT OF DONALD RATAJCZAK

I greatly appreciate being invited to offer testimony on the state of our economy at midyear.

Inventory Building Started the Year

As the year began, tax law changes already had caused substantial shifts in purchasing patterns for capital goods and consumer durables. As a result, final demand was enhanced by more than $12 billion in the fourth quarter at the expense of the first quarter. Manufacturers, who had been liquidating inventories throughout 1986, began rebuilding inventories as a result of this unexpected increase in fourth quarter final demand. Moreover, industrial materials prices had ended their decline in August and were rising sharply in the fall. Thus, the cost of storing inventories was falling, as short-term interest rates continued to decline modestly. Automobile producers also increased inventory sharply in the first quarter.

Also the dollar's decline, which had persisted for more than a year but had only begun to influence import prices in the third quarter of 1986, began to slow the growth of imports stimulate exports. The narrowing of the trade deficit in inflation adjusted terms aided increased industrial activity in the United States, further encouraging inventory accumulation and spawning increased capital spending activity. As a result, the industrial production index rebounded in the first six months and is now nearly 3% above previous year levels. Although manufacturing employment is only two thousand above a year ago, the trend now appears to be upward both for manufacturing employment and activity.

An anticipated reduction in construction also arrived in the first half, although the decline in nonresidental construction continues to be milder than expected while the slump in multi-family starts appears to have developed more rapidly than expected. Many nonresidential construction projects require a much longer development period. Thus, the restraint of the tax measures upon office contruction probably will be delayed until the last months of 1987 and 1988. Even so, inflation adjusted construction expenditures should decline by more than 3% in 1987.

Economic Surprises

Economic surprises during the first half of this year include the excessive first quarter production schedule of the automobile industry, the April surge in interest rates, and the inflation jitters in May that have since diminished.

Why automobile production was so vigorous early in 1987 is unclear. Perhaps, the industry desired to display significant supplies of all models to

stimulate sales. Producing for 11 million sales when 10.3 million was a more realistic projection led to significant auto inventories that are gradually being reduced in the second and third quarters. Even now current production schedules prevent bloated inventories from expanding further. As automobile financing and pricing incentives, are removed,production must fall further during the third quarter. End of model year discounted financing incentives again may be used to sell excess automobiles.

Sharp increases in inventory investment during the winter months would have caused interest rates to increase significantly except the Federal Reserve chose to accommodate this increased activity. (Money growth slowed, but increasing short-term interest rates reduced the desire to hold short-term liquidity in checkable depoisits. As a result, a shift away from money based assets apparently was more than sufficient to account for the reduced growth of money aggregates.) During April, further dollar weakness raised rised inflationary concerns in the financial markets. A modest tightening in monetary policy and a substantial increase in inflationary fears led to sharp interest rates in April and early May.

Rising inflationary concerns continued through the middle of May, when unjustified fear about drought in the midwest caused commodity prices to rise sharply. Fortunately, the drought fears were premature and the interest rates have since come down. Nevertheless, for the first time since 1984 increasing inflationary worries were being expressd by many investors.

In comparision to my own forecast at the beginning of this year interest rates currently are higher than had been anticipated 8.5% yields on government bonds was not expected until early in 1988. The dollar also was weaker than had been expected, although this only accelerates the decline I had anticipated later this year. Of course, the weaker dollar has helped to improve trade balances more rapidly than had been anticipated. In particular, exports of American goods have improved more than had been anticipated. However, these adjustments are relatively modest and do not significantly alter the economic conditions that have been emerging for some time.

Outlook

For the next four quarters I see a significant slowing in consumer support for economic expansion. Automobile sales may rise slightly in the second half, as they were unusually depressed by sale shifts early in the first quarter. However, reduced housing activity will take its toll upon furniture and appliance sales during the second half of this year. Also, wages are growing less than 3% while inflation duirng the first five months has increased at a 5.4% pace. This exhaustion of purchasing power will slow the volume of sales in the nondurable and service sectors. Consumer spending is expected to grow only 2% after inflation in 1987 as compared to 4.1% last next.

Although the household sector will experience reduced income taxes in 1988 as marginal tax rates are reduced to 15 and 28 percent, low income households may actually face increased tax burdens as a result of the rise in social security taxes next. Savings, which are currently at 3.5% are not expected to fall any lower, especially as the dramatic increase in asset values that encouraged reduced savings will be more difficult to acheive in the the economic climate I see in 1988. Thus, consumer spending probably will remain at a relatively subdued 2.5% after inflation next year.

Multi-family units will be started at less than 500,000 for the remaidner of this year as compared to 635,000 last year. No significant rebound in rental units is expected in 1988. Single-family housing units are not as adversely impacted by the new tax laws as rental properties, but they are affected by the abililty of new families to afford housing units. Risibg mortgage rates during the spring have reduced the affordability of housing, while significant price increases in the strong regions of the country, such as New England and the Mid Atlantic States, have further diminished the ability to purchase housing. Despite relatively promising starts during the first four months, that single-family starts will average only 1.15 million for the year. A decline to the vicinity of 1.1 million is currently expected for 1988.

Despite relatively good nonresidential construction acting early this year, definite declining trend in office and shopping center activity will not be offset by any modest improve next in industrial constuction. The construction component of other structures will be falling for the remainder of this year and also will fall by more than the 5% after adjustment for inflation in 1988.

Fortunately, the energy component of other structures is beginning to rebound. Although active rig counts are less than 100 above their low point a modest upward trend appears to be developing. Petroleum prices remain several dollars too low to stimulate significant exploration while natural gas prices also currently provide few incentives for exploration. However, prospects for rising energy prices ahead is beginnig to generate a modicum of exploration activity. When this improvement is combined with weakness in construction, the other structures component of fixed investment should show a modest downward drift over the next two years.

Fortunately, improving export opportunities and the reduction of import penetration are beginning to stimulate capital appropriations. Also, the slump in the computer and semiconductor industries appears to be diminishing. After inflation, spending on plant and equipment should increase nearly 3% this year and should also show satisfactory rates of expansion in 1988.

However, the largest area of improvement will be in the trade accounts. Adjusted for inflation, net exports already have improved from a $163 billion defict last summer to a deficit of less than $134 billion in the winter months. Further improvement to a deficit of only $112 billion by the end of 1987 and an average of a $90 billion deficit trade in 1988 is anticipated. More rapid improvement is not expected because of several impediments to improving trade positions. First, oil imports have been unusually low as domestic inventories of crude petroleum have declined. Despite the need for more than 2.5 billion barrels of imported oil a year given our country's current consumption and production conditions, or nearly 210 million barrels a month, only 168 million arrived in April, the last reported month. Oil imports almost certainly will rise in the months ahead. Second, many of our trading partners are not expanding their economies very rapidly. Economic growth in the OECD continues to slow to a rate of less than 2.5% while the German economy may grow only 1.5%. At the same time, the debt crisis in Latin America continues to keep that continent from rebuilding its imports of American goods. Third, any significant legislation that restrains trade flowing into the United States almost certainly will be followed by similar trade restraint programs in other industrialized countries. This could jeapordize the modest expasion in export activity. Fourth, the dollar already has fallen to levels that reestablish American cmpetitiveness in many of the industrialized countries of the world. Nevertheless, the dollar could fall further as foreign investors become

concerned about the magnitude of dollar based assets they are holding in their portfolios. The downside potential for the dollar is almost suddenly less than 10% unless cost conditions begin deteriorating in the United States relative to our competitors. At the present time, manufacturing costs in the United States are growing more slowly before currency adjustment than in any of the other industrialized countries.

Excluding inventory investments, the above projections lead to economic expansion of slightly more than 2.5% for the next 18 months. Prior to accumulating inventories during the first quarter, manufacturers had been liquidating inventories for much of the past two years while wholesalers and retailers maintained a relatively constant relationship between their inventory holdings and their sales activities. Falling industrial prices greatly penalized companies who held excess inventories while unutilized capacity assured immediate delivery if inventories became unexpectedly lean. Early this year, by contrast, deliveries began being delayed while industrial prices began rising. Not surprisingly, manufacturers began accumulating inventories. Inventories are continuing to be accumulated at midyear. This shift from liquidation to accumulation already has added significantly to economic activity in the first quarter and should continue to add to industrial activity over he next twelve months. Thus, with aid of inventory accumulations, the economy will probably grow 3% in the next twelve months.

Of course, if another bout of inflationary jitters leads to rising prices for industrial materials, and if the Federal Reserve again restrain the natural increase in short-term interest rates that would temper any speculative inventory holdings, more rapid economic growth could be acheived temporarily. Needless to say, such a failure to react to increasing industrial inflation could lead to the economic excesses that procede economic declines.

Inflation

Fortunately, inflationary fears have exceeded inflation potential in recent months. The dollar's decline has created double-digit price gains for imports and these increases have been enhanced by a rebound in energy prices, but wage costs have remained remarkably subdued. In May, the hourly earnings index was only 2.2% above previous year levels. Wage compensation per hour worked will increase less than 3% this year, less than the increase in 1986. Although productivity gains continue to prove disappointing, labor costs are rising only slightly more than 2% per unit of goods and services produced. The higher import prices, increased energy costs, rebounding meat prices, and higher price markups than normally develop as inflationary psychology intensifies can only push the inflation rate to less than 4% relative to 1986 averages.

However, much of the wage moderation this year is the result of unusually favorable inflationary performance last year. Which the surge in energy and meat prices, which contributed to to the 5.4% increase in the CPI during the first five months will not add appreciably to inflation later this year, increasing wage pressures in response to that inflationary episode will generate higher inflation rates over the next twelve months than have been experienced over the past four years. Wage compensation will be further increased by social security tax increases next January. Even without minimum wage legislation, which would further exert upward pressures upon the entire wage scale, as seasoned workers would seek to maintain their traditional wage differential relative to entrance level workers, wage compensation per hour could be expanding nearly 5% next year. Unless productivity gains rebound significantly,

and productivity normally performs poorly when infaltionary pressures begin to intensify, inflation approaching 5% may be in store for 1988.

Favorable Outcomes

The most favorable surprise would be more rapid improvement in our trade deficit than envisioned here. In order for that to be achieved, however, increased purchasing power must flow to Latin America or the other industrialized nations must grow more rapidly than currently projected. Japan is making an effort to increase growth of its monetary aggregates and stimulate its domestic economy through spending and tax initiatives, but American producers are not significantly benefiting from increased economic activity in Japan. Germany continues to accept its current econmomic policies even though they are generating less than 2% growth in that country.

Of course, better management of resources, especially in the service sector, could lead to increased productivity gains. Traditionally, companies have been less prone to minimize costs when inflationary pyschology is intensifying, as they can meet profit objectives through greater price markup, unless they are facing significant competition. As the dollar declines in value, manufacturing faces reduced foriegn competition. Nevertheless, better productivity performance than has occurred in the past could reduce inflationary prospects in the second half of this year. Interest rates could then fall significantly and capital spending could grow more rapidly than expected. Furthermore, reduced inflation would lead to greater consumer spending. Indeed, economic activity probably would increase sufficiently to insure undiminished employment growth. Clearly, this is the upside surprise I would like to see, but see no evidence that it is developing.

Unfavorable Outcomes

One of the major downside risks is that the excess construction product that currently exists in virtually all the metropolitian areas in the United States exerts sufficient reductions in the value of real estate to undermine the loans of financial institutions and seriously restrict the financing of new construction projects. As a result, the construction slump could develop more quickly and begin to undermine the ability of financial institutions to serve their role as an efficient intermediary. As banks already jeapordized bypoor loans abroad, agricultural problems, and energy loan problems, the downward cascading real estate values could lead to a relatvely severe financial crisis. However, many of the real estate properties that are subject to such price declines already have experienced some price weakness.

Certainly, further problems with loans to developing countries and even significant corporate failures could lead to undesirable financial consequences. The corporate and financial sectors of the economy are less capable of handling adverse financial conditions than in the past.

Although speculative inventory investments temporarily would increase industrial activity, the downside risk associated with this condition more than offset any favorable short term benefits provided by more rapidly growing economy.

Finally, one of the primary sources of economic growth over the next two years will be improving trade balances. A substantial past of this improvement will be from of expanding exports. Any movements worldwide to shrink the

attractiveness of world trade will substantially undermine the relatively modest economic expansion we currently are enjoying. Some of the trade legislation currently being considered by this Congress, whether or not justified by previous performance by our trading partners, could encourage trade retaliation from abroad.

Policy Suggestions

Unfortunately, large government deficits are reducing the policy flexibilty that government ought to have to respond to changing economic conditions. The dramatic trade deficit that has made the United States a significant debtor nation must be alowed and eventually reversed. This requires an increase in our industrial orientation and a relative reduction in our tendency to support consumption. Reductions in the federal deficit will release resources to industrial activity and return capital to foreign investors. Thus, a program of continuing to reduce the government deficit should proceed.

Any revenue raising programs that may be necessary to lower goverment borrowing should be designed to reduced consumption rather than slow production. Concerns about increasing the tax burdens for the needy can always be addressed by increasing a low income tax credit in the income tax codes. General sales tax and excise tax programs are regressive if they are the only tax change

While some trade legislation may be desirable to provide the executive branch with bargaining tools in order to negotiate increased access to foreign markets, legislation that protects American Industry from and more efficient production abroad should be avoided. Any quotas that may be temporarily negotiated should be executed by the sale of import licences so that the US Treasury and not our competitor's corporate treasurer will receive gains from access to our markets under such conditions.

The Federal Reserve should to place the restraint of inflation as its most important objective after the maintenance of a healthy financial system. Enhanced economic growth certainly is desirable, but undo Federal Reserve easing in order to achieve such an outcome is likely to fail. Recent, statements by several Federal Reserve officials which showed greater concern for economic growth than for controlling inflation may have added to inflationary jitters. Monetary expansion during a period of when inflation is beginning to intensify may lead to a widening of the gap between finance charges and the inflationary returns that can be gained from holding speculative inventories. More growth could be achieved for a time, but economic imbalances created by such a policy ultimately would lead to a correction and the decline would occur after increase inflation had become embedded in the cost structure of American industry.

Moreover, corporations tend to be more eager to seek margin enhancements rather than cost reductions in an infationary environment. This results in reduced productivity gains further increasing inflationary conditions. Legislation that might help increase the efficient allocation of resources rather than a monetary policy that supports economic growth at the expense of inflationary containment should be sought.

I hope my comments will aid you in your midterm review of the health of the American economy. Thank you.

Senator SARBANES. Well, gentlemen, thank you both. It's been a long morning. We certainly appreciate the thought and the care which have gone into these statements and we are very grateful to both of you.

Mr. Ratajczak, I wanted to ask one question. In your prepared statement you say you expect the trade account deficit to be $90 billion by next year.

Mr. RATAJCZAK. That's the end of next year and that is on a constant dollar basis. That is not in current dollars. So it is not the issue which will determine the amount of capital flows between our country and other countries.

Senator SARBANES. Well, what do you expect it to be on a nominal basis?

Mr. RATAJCZAK. On a nominal basis, it will still be in the vicinity of $140 billion.

Senator SARBANES. Well, what's the benefit of using this kind of figure to discuss the problem instead of $140 billion?

Mr. RATAJCZAK. Well, there are several problems you're looking at. The issue we were looking at here is what is going to happen to the use of American resources. And looking at the peak of $163 billion deficit, that meant a significantly greater amount of displacement of American resources by imports than if we got to $90 billion.

It's the resource displacement that determines the amount of job creation or job loss in the overall economy and which leads directly into GNP.

So if the question is, what is the impact of the trade deficit on employment and on GNP, you want to consider inflation and adjust the deficit.

If the question is, where is the dollar going and what's going to be happening to the desires of foreign investors to move into the United States, you look at the nominal values.

So you need to look at different values for different questions being raised.

Senator SARBANES. How much are we going to have to take out of our future standard of living in order to service the enormous debt that is being held abroad as a consequence of our large trade deficit?

Mr. RATAJCZAK. Well, of course, we're still accumulating this debt and, as I say, next year at a rate of about $140 billion—well, that would be the trade deficit. We still have what we call a positive balance on our factor incomes, but that will be shrinking. We will probably be borrowing something on the order of another $120 billion from abroad next year. It will be shrinking, but it's shrinking at a relatively slow rate and indeed it's going to be very hard to get those capital borrowings from abroad down below $100 billion a year. We could very well see our trade debt going up to a trillion dollars by 1993.

Senator SARBANES. Let me ask both of you, what are the implications of that for the standard of living in this country?

Mr. SINAI. Actually, near term, the net debtor position in terms of the interest charges on our position as a portion of GNP is relatively small. In fact, it would not become positive by our estimates

until 1988. In 1990, we're talking about half a percent, at most 1 percent of GNP.

I think, though, when you add that to the high interest charges on the Federal debt and combine them, you have historically quite a high interest payment burden for the country on its outstanding public debt and as a result of its net debtor position. We have been a net creditor for so many years that when we ran surpluses and had interest charges on what we earned abroad, it helped offset what we had to pay on our Federal debt. That is no longer going to be the case and the trend as it now stands is very negative.

Now the claim against the standard of living operates in insidious ways. For example, because we are running these large trade deficits and big budget deficits, I think interest rates are considerably higher than they would be otherwise. My own econometrically based estimates would suggest that long-term interest rates are easily 2 percentage points above what they would be if we were not running these big budget and trade deficits—at least 2 percentage points. Translate that into mortgage rates and you're talking about 2.5 or 3 percentage points. Translate that into monthly payments for the typical American household and you get some idea of the extra burden as it cuts into the standard of living in terms of loan repayments as a claim against current income. It is really very considerable.

Senator SARBANES. I think this is an important point to develop. The President is always talking about tax and tax and spend and spend, but in fact, what the Reagan administration has been doing is pursuing a policy of borrow and borrow and spend and spend. And the implications of that I think for the standard of living are extraordinarily serious.

We've had an enormous runup in debt of all sorts—private debt, individual debt, corporate debt, and Federal debt. Then, of course, there has been the deterioration of our status internationally, where we've gone from being the largest creditor to the largest debtor in 5 years' time.

Mr. SINAI. In a way, it is a kind of tax. We cut taxes very sharply and for good reasons in the early years of the 1980's. Part of that resulted in very large budget deficits which, in turn, given monetary policy, produced much higher interest rates than otherwise would have occurred which, in turn, produced an overvalued dollar which, in turn, contributed to our loss of competitive position abroad which, in turn, contributed to our trade deficit and growing trade debt which, in turn, now gives us downward pressure in the dollar with higher inflation and higher interest rates.

In a way, my own feeling is that the higher interest rates are just another kind of tax which we have exchanged for the lower tax rates that we have put into place from 1982 to 1987 and in making a judgment as to whether it's good or bad there are differential impacts on individuals and businesses when you cut taxes and when in exchange there is a tradeoff that shows up in higher interest rates and differential behavior industry by industry in the economy.

It's a little hard to make an overall judgment, but in the longer run, no country can increasingly be in debt without having its currency come under pressure provided that competitors are compet-

ing and doing fairly well. And eventually, it means austerity and difficulties in the standard of living in one form or another.

I think the only question is when. In some instances in history, it can be as long as 10 or 15 years. I couldn't tell you that the chicken really comes home to roost in 1 year or 2 or 3 or 5 or 8. It can be a long time. But I think it's an undesirable situation for any country.

Just one other quick point, thinking back to what Mr. Sprinkel said earlier or someone said about the desirability of investing in the United States. Our net debtor position involves a great deal of American IOU's that foreign investors hold as they have lent to us as we have spent more than we've saved.

Also, there is more direct investment in real estate and in businesses by foreign investors in the United States. One can look at that as a plus because we are such an attractive place to invest. But you can also look at it as a negative because we do lose some control over our own means of production as more and more of our businesses are sold to foreign investors who increase their equity in the United States.

So one way or another, this society will have to come to grips with this deficit problem.

Senator SARBANES. Does either of you see anything significant that came out of the Venice Summit?

Mr. SINAI. Well, I think it's a constructive road to be on and better than not being on the road at all, which is some attempts, although not satisfactory, for the major countries to establish a way to coordinate policy in response to objective signals to sustain world expansion.

To me, that is what has been constructive about the Venice Summit and the various meetings. Nothing really tangible specifically was done at the Venice Summit other than the process pushed further along.

Mr. RATAJCZAK. Well, I think what Allen Sinai is saying is that the idea of economic summitry is good and talking together is good. The Venice Economic Summit was nothing special as an economic summit.

While there was some ideas expressed in terms of coordinating activity based upon various indicators, there wasn't any rule established so that there is no evidence that any coordinated activity will be forthcoming.

But nevertheless, talking about coordinated activity is probably useful and I do think that we have received some macroeconomic response from Japan as a result of the pressures leading up to the Venice Economic Summit. There is no evidence that there's been any response from Germany.

Senator SARBANES. I think those summits are becoming extravaganzas, and the hard work that ought to be done in terms of careful development of a coordinated economic policy is not being done. We have had a shift away from the use of established institutions for coordinating economic policy—OECD and other forums through which we've worked—and, of course, this administration, to some extent, has gone off unilaterally or bilaterally in dealing with world economic problems instead of developing a careful coordination. This thing has become a media extravaganza.

Mr. SINAI. You could save a lot of government money and private sector money by accomplishing what goes on there in smaller committees. I don't like meetings myself. I can think of other ways to spend my time.

Senator SARBANES. Let me ask you another question. How do we get out of the straitjacket that we've put ourselves in, in terms of being able to have some discretion in the use of our economic tools? My perception of where we are is that if we have a downturn the ordinary tools that we would ordinarily use at that point we can't have recourse to. The tools aren't in the toolbox, so to speak. You just can't make use of them under the circumstances.

Mr. SINAI. That is my view. I think that's the problem.

Mr. RATAJCZAK. That's my primary concern.

Mr. SINAI. I have no real suggestions. The legacy of the past is the imbalances that developed off our own fiscal and monetary policies. It's not easy to work out from under the current way policy is made in the United States and in the international economic sphere.

Senator SARBANES. Well, gentlemen, thank you very much. We appreciate your testimony. It was very helpful.

[Whereupon, at 12:30 p.m., the hearing recessed, to reconvene at 10 a.m., Wednesday, July 1, 1987.]

STATE OF THE ECONOMY AT MIDYEAR

WEDNESDAY, JULY 1, 1987

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes, Melcher, Bingaman, and Symms; and Representatives Scheuer, Solarz, Fish, and McMillan.

Also present: Judith Davison, executive director; Richard F Kaufman, general counsel; and Stephen Quick, chief economist; and William Buechner, Dan Bond, Jim Klumpner, Joe Cobb, and John Starrels, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order.

Today's hearing is the second in a series which the Joint Economic Committee is holding to examine the state of the American economy at midyear.

Today we will review America's international economic position, and will look at both our foreign trade position and our international debt position. To assist in this inquiry, we are pleased to have with us Malcolm Baldrige, Secretary of Commerce, to present the administration's views on the trade issue. Secretary Baldrige will be followed by an excellent panel of private analysts, Fred Bergsten of the Institute for International Economics, Jerry Jasinowski of the National Association of Manufacturers, Donald Hilty of Chrysler Corp., and Robert Hormats of Goldman Sachs.

There currently exists a strong consensus among economists on three points. First, the recent huge trade deficits are unsustainable; second, improving our external trade appears under current circumstances to be the primary way to keep the economy growing at an adequate rate; and third, it is essential that improvements in the trade area come about promptly, and on a significant scale, to address the burden which our external debt will increasingly place on the American economy.

The United States last year ran a merchandise trade deficit of nearly $170 billion, and a broader current account deficit of over $140 billion. These unprecedented deficits are the consequence of a number of economic policy mistakes: irresponsible fiscal policies, excessively tight monetary policies, an apparent disregard for the health of American manufacturing, overvaluation of the currency. Some, but not all, of these policies have now been reversed, and

there is cautious optimism that the U.S. trade picture is likely to improve in the months ahead.

While such an improvement is welcome, it's not a cause for celebration since the problem from past trade deficits remains in the form of a large and growing burden of external debt. The real time for celebration will come when we begin to reduce the size of the external debt, not simply when we stop the growth of the annual trade deficit.

Today the United States has a net debt greater than that of Mexico, Brazil, and Argentina all put together. For 1987, all forecasters agree that the United States will post another large current account deficit, which will have to be financed by adding to the total of our outstanding debt.

By all accounts the world's greatest debtor, the United States will add an amount of new debt in 1987 equivalent to the total outstanding debt of Brazil, the world's second largest debtor.

These large external debts severely limit our ability to control our own economic future or shape the evolution of the world's economy. Unfortunately, our status as a debtor means that we must craft domestic economic policies with an eye to their potential appeal to foreign creditors. It is clear, I think, from the Venice Summit that our changed status may well have cost us influence with our allies.

A successful trade policy for the United States must be one which not only reduces the trade deficit but moves it to a trade surplus. Only by posting surpluses on our annual trade accounts can we begin to reduce the size of our external debt. The longer we wait to start posting such surpluses, the larger will be the accumulated debt which must be repaid.

The challenge before us, therefore, is to create a trade policy that will enable us promptly and systematically to transform the annual trade deficits into surpluses. Such a policy will require action on a number of fronts, including the dollar, the Federal budget, trade law reform, and meaningful initiatives to enhance the competitiveness of American industry.

This is obviously a large challenge and we look forward to hearing from Commerce Secretary Baldrige this morning about plans for meeting the challenge.

Mr. Secretary, we are pleased to welcome you to the committee and we would be happy to hear your testimony.

STATEMENT OF HON. MALCOLM BALDRIGE, SECRETARY OF COMMERCE

Secretary BALDRIGE. Thank you, Mr. Chairman.

I am pleased to appear before the Joint Economic Committee to discuss the role that U.S. trade has played in the world economy over the past few years and the outlook for U.S. and world trade over the next few years.

I have submitted a more detailed prepared statement for the record. In my oral summary, I will focus on what lies ahead, what needs to be done to meet those challenges.

The international interdependence brought about by growing trade and capital flows has generated many benefits, but it also im-

poses obligations on all nations to pursue policies that will maintain and enhance the global trade environment.

During the 1980's, the world trading system continued to make advances. The gains, however, could have been better were it not for the global recession, volatile oil prices, a debt crisis in the LDC's, and growing worldwide trade imbalances. Nevertheless, with all those, in volume terms, 1986 trade levels are estimated to have been about 15 percent above 1980.

This expansion was a critical factor in bringing down global inflation rates, increasing consumer choices, and the efficiency of production around the world and raising living standards in a number of economies. Yet we must deal with the problem of imbalances in global trade in a way that will allow continued economic expansion in the United States and abroad.

Enlarging U.S. trade and current account deficits over the 1982 to 1986 period have not been without their costs. They have disrupted industry, production, and employment in the Unted States. For the world, however, enlarging U.S. trade deficits have played a major role in recovery from the global recession of 1982. In effect, the enlarging merchandise trade deficits of the United States served as an economic locomotive for the world.

About half of the European Community's GNP growth in 1984 was due to increased exports to the United States and about one-quarter of the European Community's growth in 1985 was due to exports solely to the United States. As much as one-half of Japan's growth during 1982 to 1985 was due to increased exports to the United States.

An increasing number of foreign economies have become dependent on the U.S. market as a major target for export led growth strategies which have become the principal basis for their economic growth. In addition, the large U.S. deficits have quickly moved the United States from a net creditor international investor position to a net debtor position.

Obviously, Mr. Chairman, these developments simply can't continue indefinitely. The United States has seen the worst of our trade and current account deficits. While trade data will likely fluctuate somewhat from month to month, our merchandise trade balance for the first 4 months of this year improved by $3.3 billion on the CIF basis over the prior 4 months and our manufacturers' trade balance improved by $2 billion the first 4 months of 1987. There's been a significant improvement in our high tech trade balance with a first quarter 1987 surplus of $700 million contrasting with the fourth quarter of 1986 deficit of $200 million. That's an improvement of almost a billion dollars in our high tech trade balance.

These amounts may be relatively modest, but they are significant favorable changes from earlier trends and we expect them to continue and to accelerate.

In volume terms, improvements have been even more significant. Exports increased by 7 percent from the third quarter of 1986 to the first quarter of 1987, while imports actually shrank 2.4 percent. This means instead of providing a drag on GNP, trade is now resulting in U.S. economic growth.

I expect improvement in the merchandise trade deficit in dollar terms this year, improvement in volume terms will be particularly significant. The trade deficit, as measured in constant 1982 dollars, should improve $25 or $30 billion this year. The real trade improvement this year should contribute about a quarter of the total growth in our GNP, which is projected to be 3 percent or a little more. In short, a quarter of that GNP growth will come from that improvement in our trade balance.

This improvement has not occurred as rapidly as expected, however. Foreign suppliers have been determined to maintain their U.S. market share in the face of higher costs imposed by the lower valued dollar, and this has squeezed their profits. But this is a typical reaction of a businessman rather than an economist; these countries abroad have spent so much time and invested so much money in building up marketing distribution systems and manufacturing to take care of the U.S. market that when the dollar-yen mark changes, whatever country you're talking about, instead of raising their prices to compensate for that increase in cost, they are holding their prices as long as they can down to where they are because market share is No. 1 to them and they don't want to see it go.

In absolute terms, the changes so far are small, but the trends are markedly different from earlier periods. We are now seeing unit labor costs of foreign competitors increasing more rapidly than ours are. Unit labor costs in our industrial trading partners rose an average of 27 percent in 1986 compared to a very small decline for the United States. For Japan, for example, the 1986 increase was almost 43 percent in their unit labor costs, while ours declined slightly.

These figures represent relative productivity changes as well as the effects of exchange rate movements.

We've finally turned the corner on U.S. trade, but the process of adjusting global current account imbalances has just begun. Shrinking these imbalances poses difficult problems for the United States and the global economy that we need to understand if we're going to deal with them correctly. It's in the interest of the United States to reduce our trade and current account deficits as quickly as practical. But if we are to do so while maintaining economic growth in the United States and abroad, time will be needed to achieve an orderly decline, perhaps a time period of 4 to 5 years.

This implies some further changes in the U.S. international investment position. The net holdings of foreigners are still relatively small compared to our GNP—about 6 percent at the end of 1986 compared to about 40 percent for Brazil, which is a country the chairman mentioned. But even a further growth in our negative net international investment position would result in debt servicing payments that would probably be well under 1 percent of GNP by the early 1990's.

This brings us to the important point to how global trade imbalances will be narrowed. Our foremost priority is to bring the Federal budget deficit down. This will reduce the need for foreign capital to finance the gap between domestic U.S. savings on the one hand and private investment and the Government deficit on the other.

The savings-investment gap has been the fundamental factor in the growth of the U.S. trade deficit. Reducing excessive Federal spending is paramount for reducing the trade deficit.

Moreover, our analysis shows that even though the United States is rapidly becoming a more service-oriented economy, merchandise trade will continue to dominate the current account performance, and the vast majority of the improvement that's going to occur will have to come in our manufacturers' trade. Indeed, to balance its accounts the United States will over the long term have to export about as much manufactured goods as it imports.

The United States is not going to deindustrialize, as some have speculated. Indeed, we are seeing now the beginnings of something of a resurgence of U.S. manufacturing. In 1986, for the first time since 1950, U.S. manufacturing productivity outgained our major industrial partners, all of them. Our productivity in manufacturing went up 3.6 percent last year. That was ahead of our major competitors.

Changes in U.S. manufacturers' trade performance affect global manufacturers' trade flows obviously and will therefore strongly affect some of our trading partners, particularly those with large current account surpluses based on large manufacturers' trade surpluses.

Narrowing U.S. deficits will present challenges not just for the United States but our trading partners as well. The 1986 current account deficit of $140 billion was matched by the current account surpluses of Japan, Germany, and Taiwan that totaled about $137 billion. So, in effect, our current account deficit was just about equal to the current account surpluses of Japan, Germany, and Taiwan, and those three mostly derived their surpluses from manufacturers' exports.

About two-thirds of the combined 1986 global current account surpluses of those countries—Japan, West Germany, and Taiwan—which were $86 billion, $36 billion, and $15 billion—about two-thirds of that was accounted for by their bilateral surpluses with the United States.

Managing the narrowing of global trade imbalances—that is, the U.S. deficits and the complementary surpluses of our trading partners—narrowing that gap must proceed in tandem with the narrowing of our budget deficit. They have to go together. Achieving this in tandem narrowing while maintaining economic growth in the United States is the most critical problem of the next few years.

Here in the United States the relatively slow shrinking of our deficits that is necessary to allow adjustment both here and abroad may try the patience of some and raise cries for dangerous trade restricting actions, but at the same time as the surpluses of our trading partners shrink, we don't want to forget that the pressure for protectionist actions from affected industries in their economies is going to increase even more than it is now, especially if their economic growth slackens.

The transition to a more sustainable basis for long-term growth of the world economy, therefore, is going to require coordination of international economic policies between the United States and our trading partners. It will also require that individual countries

avoid beggar thy neighbor restrictive trade policies that only aggravate the situation in the longer run.

During this period, it's going to be especially important that the United States as a leader in the world economy set the example to be followed. It would be exactly the wrong thing to do, Mr. Chairman, if we succumbed to protectionist policies at a time when it's obvious that we have turned the corner on lowering our trade deficit and that we are beginning to see our exports increase. Those policies of protectionism are addressing the problems of the late 1970's and the early 1980's, but they are not addressing the problems we are facing today or tomorrow.

Mr. Chairman, in my prepared statement for the record I have reviewed the actions taken and initiatives advanced by this administration to deal with our U.S. trade deficits and global trade problems and I think that record is impressive.

It includes actions to achieve a more realistic dollar exchange rate and a better international macroeconomic policy coordination. It includes a realistic approach to the LDC debt situation. It includes launching the Uruguay round of GATT. It includes a much more aggressive implementation of U.S. trade laws and bilateral initiatives in dealing with trade and investment issues.

Much remains to be done in each of these areas and in the initiatives we have advanced American business is either competitive today or getting competitive. I think that fact is sometimes not understood, so I'll just make the statement again if I may. In my opinion, American business is competitive at the exchange rates we are seeing today with our major competitors.

We are going to continue to press for trade legislation that enhances that American competitiveness and that increases our leverage in our international negotiations. As you know, the administration continues to urge the Congress to pass a trade bill that the President can sign and has expressed a number of strong reservations regarding the package that's now emerging from the Senate. I urge the members to this committee to work with your colleagues to fashion a bill that is responsible and truly in the national interest.

Thank you very much, Mr. Chairman. That concludes my oral statement.

[The prepared statement of Secretary Baldrige follows:]

PREPARED STATEMENT OF HON. MALCOLM BALDRIGE

Mr. Chairman, I am pleased to appear before the Joint Economic Committee to discuss the role that United States trade has recently played in the world economy and the outlook for U.S. and world trade over the next few years.

I will first review recent events in the world trading system. I will then turn to the near and medium term outlook for U.S. trade and the implications for the United States and our trading partners. I will conclude with a review of recent administration actions and what remains to be done by the United States and its trading partners.

WORLD TRADE IN THE 1980s

Benefits and Obligations of The World Trading System

In today's world, international trade is a critical factor in determining the wealth of nations and global living standards. As technology advances more rapidly and as industrialization continues, it becomes increasingly true that no single nation can excel in every technology and efficiently produce every good. No nation can achieve its full economic potential without importing goods, services and technology from abroad. Increasing the volume and efficiency of global production and the wealth of individual nations requires the free flow of goods and capital among nations.

Every country is to some degree affected by the policies and economic performance of others. And the economic policies and performance of every country affect the performance and living standards of other nations.

This international economic interdependence imposes obligations on all countries to pursue policies that will maintain and enhance the global environment. No nation is exempt from these obligations.

Global Trade Performance in the 1980s

During the 1980s the world trading system made significant advances. Measured in dollar terms, world merchandise exports increased from $2.0 trillion in 1980 to $2.1 trillion in 1986. These dollar valuations, however, are distorted by fluctuations in the dollar exchange rate. In volume terms the 1986 trade levels are estimated to be about 15 per cent above 1980. This expansion has been a critical factor in bringing down global inflation rates, increasing consumer choices and the efficiency of production and powering economic growth and rising living standards in a number of economies.

These achievements were made despite difficult problems. These included: the disruptive effects of oil prices that peaked in 1981 and then fell by 57 percent to their 1986 levels; widespread inflation and a global recession that halted the growth of trade volumes in 1981 and actually reduced trade volumes by 2 percent in 1982 before a resurgence of growth beginning in 1983; an LDC debt crisis that significantly affected international trade volumes and disrupted traditional trade patterns.

We can take satisfaction in continued progress of the world economy and its display of remarkable strength and resilience in weathering these problems. But there is no basis for contentment or euphoria. The LDC debt problem has been contained and mitigated, but not resolved. It continues to affect the economies of both the troubled debtors and their trading partners. There have been four years of growth in world trade since 1982, but now we face unsustainable imbalances in global trade flows and major problems in narrowing these imbalances, while achieving continued economic expansion in the United States and abroad.

Global Effects of U.S. Trade in the 1980s

Strong U.S. economic expansion during the 1980s and exceptionally strong growth of U.S. imports that produced enlarging U.S. trade deficits played a major role in recovery of the world economy from the global recession of 1982. U.S. import growth sparked much of the economic growth in Japan, Europe and East Asian NICs and added to the trade surpluses necessary for many LDCs to service their debts. In effect, the United States served as an economic "locomotive" for the global economy.

Recent large U.S. trade deficits have had short term benefits for both developed and developing countries. About one-half of the European Community's GNP growth in 1984 was directly due to increased exports to the United States and about one-fourth in 1985. Japan also benefited significantly from the growth of the U.S. trade deficit--as much as one-half of Japan's growth during 1982-85 was due to increased U.S. imports from Japan.

Latin American LDCs as a group ran a 1986 merchandise trade surplus of $14.4 billion with the United States--an almost $15 billion swing from a 1981 U.S. surplus of $0.3 billion. U.S. imports are also critical to a number of other countries including the Asian NICs and other less developed countries. Forty percent of South Korea's merchandise exports and 48 percent of Taiwan's went to the United States.

In short, an increasing number of foreign economies have become more dependent on the U.S. market as a major target for export-led growth strategies. Moreover, several countries have become unduly reliant on constantly enlarging export surpluses as the principal basis for their economic growth.

Needless to say, Mr. Chairman, these developments cannot continue indefinitely.

Effects of U.S. Trade Performance On the United States

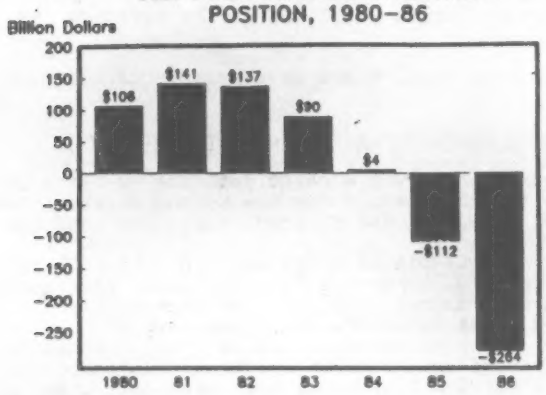
Enlarging U.S. trade and current account deficits over the 1982-86 period had both costs and benefits for the United States. They have resulted in disruptions in industry, production, and employment.

On the other hand, imports played a key role in holding down inflation and leaving U.S. consumers with increased purchasing power. Low-priced imports not only provided foreign goods to U.S. consumers, but kept pressure on domestic producers of import-competing products to increase productivity, reduce costs and maintain competitive prices. Imports stiffened resistance to inflationary wage and price increases, motivated cost-cutting measures in U. S. industry and quickened the pace of adaption and structural change within the domestic economy.

Large U.S. deficits have also moved the United States from a net creditor international investment position to a net debtor position (Figure 1). I will discuss the longer term implications of this change later in my statement. But, as I noted earlier, these large global trade imbalances cannot be sustained. The United States cannot and will not continue indefinitely to enlarge its international debtor position relative to GNP.

Figure 1

U.S. INTERNATIONAL INVESTMENT POSITION, 1980-86

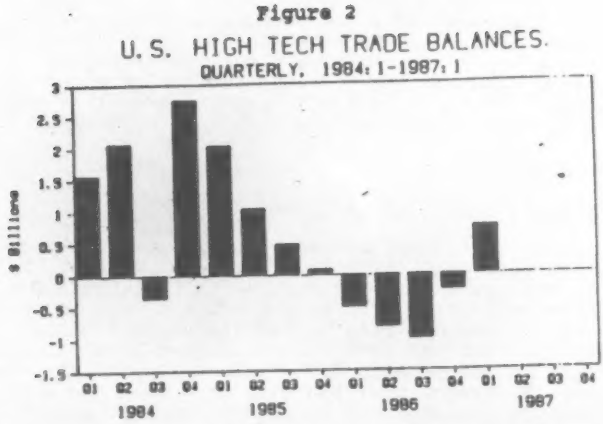


CURRENT U.S. TRADE SITUATION

Where do we stand today in the difficult task of reducing global trade imbalances--U.S. deficits and the offsetting surpluses of some trading partners?

There is every indication that we have seen the worst of our trade and current account deficits. While trade data will likely fluctuate, our merchandise trade balance for the first four months of this year improved by $3.3 billion (c.i.f. basis) over the prior four months. Our manufactures trade balance also improved by $2.0 billion the first four months of 1987 compared to the prior four months. Moreover, there has been a significant improvement in our high tech trade balance, with a first quarter 1987 surplus of $0.7 billion contrasting with a fourth quarter 1986 deficit of $0.2 billion, an improvement of almost a billion dollars (Figure 2). While these improvements are relatively modest in amounts they are significant movements from earlier trends and we expect these recent improvements to continue and to accelerate.

Figure 2



In volume terms, improvements in our total merchandise trade have been even more significant. Although in nominal terms the third quarter 1986 and first quarter 1987 deficits were almost identical, there was a significant improvement in the trade balance in real terms--almost 16 percent. In real terms, exports increased by 7 percent from 3rd quarter 1986 to first quarter 1987, while imports actually shrank by 2.4 percent. This means that instead of providing a drag on GNP, U.S. trade has now switched to a positive force on U.S. economic growth.

The relative growth rates of the U.S. and foreign economies will be important factors in U.S. merchandise trade balances over the next few months, but we expect the deficit in real terms to continue to shrink, yielding an improvement of, perhaps, $25 to $30 billion in 1987 compared to 1986.

Abroad, the effects of changing trade flows are also beginning to be felt. Given the change in the yen-dollar exchange rate, Japan's 1987 current account surplus expressed in dollars may match or top its 1986 level. But expressed in yen terms, Japan's exports--which directly affect Japanese production and employment--in first quarter 1987 were down 8.3 percent from first quarter 1986 and down 10.3 percent from fourth quarter 1986. Imports in yen terms were also down, resulting from yen appreciation.

Germany's first quarter 1987 exports have also been affected, down by 2.3 percent compared to first quarter 1986 and by 5.8 percent compared to fourth quarter 1986. German imports, in D-Marks, also declined, reflecting in part the change in terms of trade from the dollar decline.

In short, while in absolute terms the changes so far are small, the trends are markedly different. We have finally turned the corner on U.S. trade and the process of adjusting global current account imbalances has begun. But shrinking these imbalances poses difficult problems for the United States and the global economy that we need to understand if we are to deal with them correctly.

THE GLOBAL TRADE OUTLOOK

An Orderly Decline of Global Imbalances

It is in the interest of the United States to reduce our trade and current account deficits as quickly as practical. However, time will be needed to achieve an orderly decline in U.S. trade deficits over a four or five year period and this gradual decline does imply some further growth in the negative United States international investment position, which was $264 billion at end 1986. Thus, assuming only a gradual decline in U.S. trade deficits, the negative U.S. international investment position will grow over the next several years. But it is important to put the current and prospective U.S. positions in proper perspective.

To begin, while the United States does today have the world's largest net negative international investment position in dollar terms, that position is small relative to our Gross National Product and does not constitute an immediate problem. At end-1986 the U.S. net investment position was equivalent to about 6 percent of GNP. At the same time Brazil's debt in dollars was significantly smaller, but was about 40 percent of GNP.

Nevertheless, our negative international investment position is a matter of concern and further growth can ultimately bring us to a position that results in net payments on international investments, rather than the traditional U.S. net receipts from international investments. Prospective U.S. debt servicing requirements, however, also need to be put in context. Even a further growth in our net negative international investment position would likely result in debt servicing payments in the early 1990s that would be well under one per cent of GNP. But servicing the debt will require surpluses in other elements of the current account and the larger the U.S. debtor position grows, the larger that these surpluses will have to be to achieve sustainable U.S. balances.

How U.S. and Global Imbalances Will Be Narrowed

This brings me to the important point of how global imbalances will be narrowed. We--and our trading partners--need to understand and anticipate that the major portion of the coming narrowing of the U.S. current account deficit will come in manufactures trade.

The primary source of deterioration in U.S. merchandise trade and current account balances has been our manufactures trade. Indeed, the slippage from 1981 to 19[illegible] in the U.S. manufactured goods trade balance was almost $150 billion--more than the $130 billion slippage in the merchandise trade balance and just about equal to the $148 billion deterioration in our current account over the same period.

Not surprisingly, our conclusion is that the majority of the improvement in the current account and merchandise trade balances that is going to occur will have to come in manufactures trade balances.

Our analysis shows that, even though the United States--like other advanced economies --is rapidly becoming a more service-oriented economy, merchandise trade will continue to dominate current account performance and, in turn, manufactures trade will continue to be the key to merchandise trade performance.

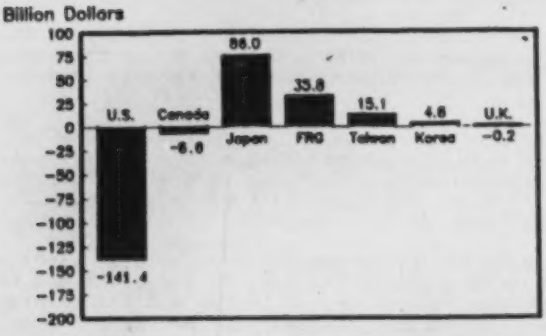
This basic conclusion about the central role of U.S. manufactures trade in U.S. transactions with the rest of the world has very important consequences for the United States and its trading partners. Because U.S. trade balances will necessarily be narrowed primarily through improved manufactures trade performance and because over the long term we will have to export more manufactures than we import, the United States is not going to "deindustrialize" as some have speculated. Indeed, we are seeing now the beginnings of something of a resurgence of U.S. manufacturing. Manufacturing production continues to achieve new all-time output highs. Moreover, for the first time since 1950, U.S. manufacturing productivity in 1986 outgained our major industrial competitors.

We still have a way to go to achieve a sustainable trade position, but the now realistic dollar exchange rate, together with improved competitiveness stemming from increased productivity, efficiency and quality will ensure eventual elimination of the large manufactures trade deficits.

This improved U.S. manufactures trade performance will have important effects on the U.S. economy. The 1986 manufactures trade deficit was equivalent to about 3.3 percent of GNP. A return to balanced U.S. manufactures trade thus implies important changes in the structure and total output of U.S. manufacturing. But these changes will also affect global manufactures trade flows and will, therefore, strongly affect some of our trading partners--particularly those that have large current account surpluses based on large manufactures trade surpluses. Countries that will likely be signficantly affected include Japan, Germany, Taiwan and Korea. The 1986 current account deficit of about $140 billion was almost matched by global current account surpluses of Japan, Germany and Taiwan that totalled about $137 billion (Figure 3). For the most part, these surpluses are derived from manufactures exports.

Figure 3

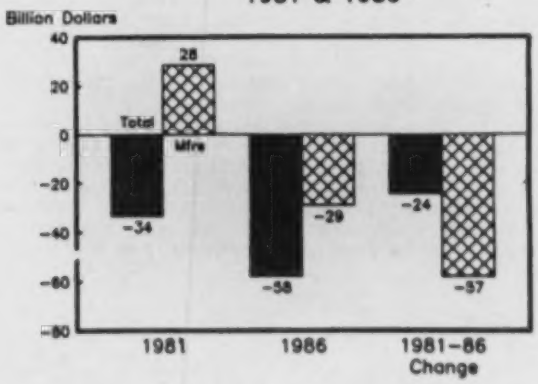
CURRENT ACCOUNT BALANCES, 1986



Shrinking U.S. deficits will also have important effects on some LDCs. The growth of the U.S. trade deficit in recent years produced offsetting improvements for LDCs that have helped them meet their debt payments. From 1981 to 1986 the U.S. trade balance with LDCs deteriorated by $24 billion, but the manufactures trade balance slipped by $57 billion (Figure 4). A significant improvement in the U.S. manufactures trade balances with LDCs--unless offset by improvements in their accounts with other industrialized countries--could hinder the ability of some LDCs to meet their international debt payments.

Figure 4

U.S. TRADE BALANCES WITH LDCS
1981 & 1986



U.S. deficits cannot be reduced without equivalent reductions of the surpluses of others. Narrowing U.S. deficits and the surpluses of others will present difficulties not just for the United States but for our trading partners as well.

Managing this transition--a shrinking of both U.S. deficits and trading partner surpluses--in a manner that will facilitate continued economic growth in the United States and abroad will require continued cooperation by the United States and our trading partners.

Implications of Narrowing The Global Trade Imbalances

Clearly, U.S. trade and current account deficits and the complementary surpluses of U.S. trading partners must and will narrow. But the speed and timing of the narrowing is uncertain and there are many potentially difficult problems along the way.

Here in the United States, because the trade deficits are often seen as hurting domestic employment and wages, a slow shrinking of the deficits may try the patience of some and raise cries for trade restricting action that would not solve the problem, but could aggravate it by leading to foreign retaliation and, possible, trade wars that could precipitate global recession.

As global imbalances continue to shrink and our trading partners face the difficult problems of adjusting to their shrinking surpluses, the pressures for protectionist actions from affected industries in their economies will increase and be difficult for them to resist, especially if their economic growth slackens. Countries with shrinking trade surpluses thus should take actions necessary to absorb the slack in their economies if they are to minimize internal disruptions and if their own growth and their contributions to global demand are to be sustained and increased. Several countries will have to move to increased reliance on domestic demand as a source of their own economic growth in lieu of dependency on constantly expanding export surpluses.

We are entering a difficult period. Instead of the "locomotive" power provided the world economy by persistently expanding U.S. trade deficits, shrinking U.S. deficits over the next few years will constitute a "drag" on the economic growth of some of our trading partners. A transition to other more sustainable bases for long term growth of the world economy will require coordination of U.S. and trading partner international economic policies. It will also require that individual countries avoid "beggar thy neighbor" restrictive trade policies that appear to alleviate immediate difficulties but serve only to aggravate the situation in the longer term.

During this period it will be especially important that the United States set the example to be followed. It would be tragic if the United States were now to adopt trade restricting measures, at a time when a major portion of the burden of a changing trade situation appears to be shifting to others.

Instead, we should continue our emphasis on the reduction of barriers to U.S. exports, actions that will benefit not only the United States but those nations that continue to support inefficient industries.

ADMINISTRATION POLICY ACTIONS IN THE 1980s

The Reagan Administration has developed and implemented a comprehensive long-term set of policies designed to resolve the U.S. trade deficit problems. These policies have begun to produce the turnaround in U.S. trade performance essential to the continued health of the U.S. and world economies. It is imperative that we continue to adhere to policies that result in a measured, steady reduction in the U.S. trade deficit, not knee-jerk reactions to short-term problems.

Achieving a More Realistic Dollar Exchange Rate

Perhaps the single most important factor contributing to U.S. trade performance during this decade was the steady appreciation of the dollar between 1980 and early 1985. While this dollar rise reflected net capital inflows to the United States based on a strong foreign perception of the United States as a productive environment for investment, it was accompanied by large deficits in the U.S. trade and current account positions.

The Administration sought a coordinated approach by the major free-world economies to support a realistic dollar exchange rate consistent with underlying market forces. The Plaza Agreement and subsequent consultations with our trading partners have contributed to the appreciation of currencies of countries whose trade and current account positions had achieved unsustainable surpluses, and helped prevent speculative swings in exchange rates that distort trade flows and other international financial transactions.

Better Macroeconomic Policy Coordination

Recognizing that divergent national macroeconomic developments and policies were a principal factor in the growth of U.S. external deficits and foreign external surpluses, the Administration has emphasized to all players in the integrated free-world economy to adopt policies designed to achieve balanced, sustainable non-inflationary growth. The United States can no longer be the only engine of global economic growth--our major trading partners must assume their share of this responsibility.

The Administration has urged Japan and the major European countries, with limited success, to adopt stimulative domestic economic policies. In addition, we continue to encourage these economies to accept and facilitate the structural changes necessary to alleviate global excess capacity in major industrial sectors.

On our part, the United States has made a sustained reduction of excessive federal spending the highest priority national objective. We are beginning to see progress in this area, and a sustainable reduction in U.S. budget deficits is in prospect. Also, compared to other major economies, the United States has undergone a greater degree of the structural adjustment necessary to rationalize production in a changing global economy.

Managing the LDC Debt Situation

The Administration recognizes that the financial problems of the major LDC debtor countries have been a major factor in changing global trade patterns and the lack of U.S. export growth in recent years. U.S. imports from these countries have grown steadily while our exports to them initially declined and have recovered very slowly. While we have been able to overcome the initial LDC debt crisis situation triggered by the trade-constricting global recession in 1981/82, the debtor countries--principally in Latin America--remain in a position that requires them to generate significant trade surpluses in order to service their outstanding debt.

The Administration advanced a strategy to deal with this ongoing problem--the Baker Plan. That plan calls for additional lending to the LDC debtors to sustain them while they accomplish internal reforms necessary to stimulate greater investment and more stable economic growth prospects. In addition, we are encouraged by recent Japanese announcements that Japan will allocate increasing portions of its external surplus toward grant aid to the LDC debtors.

Launching the Uruguay Round

The U.S. initiative to build on the achievements of the Tokyo Round of GATT-sponsored negotiations and prevent trading nations from adopting more insidious trade-distorting measures provided the catalyst for the launching of the Uruguay Round of multilateral trade negotiations.

The United States pushed successfully for inclusion in these talks of issues that are becoming of increasing importance in our trading relationships. These include the international protection of intellectual property rights, services industries, and investment policies that affect trade flows. The Administration also established a high priority for agricultural issues--the growth of distorting agricultural subsidies has provided growing global surpluses in major commodities.

More Aggressive Implementation of U.S. Trade Laws

To accord an even higher priority to eliminating major foreign barriers to U.S. exports and redressing unfair trade practices by our trading partners, the President instituted his Trade Policy Action Plan in September 1985. As Chairman of the President's Strike Force on Trade, my Department has led several important Administration initiatives against foreign practices that discriminated against U.S. exports.

The Administration, through the U.S. Trade Representative, for the first time, self-initiated section 301 cases, set deadlines for the resolutions of longstanding 301 cases, and demonstrated our willingness to retaliate when countries refused to eliminate unfair trade practices. We have made significant progress in improving domestic protection for U.S. intellectual property against unlawful foreign infringement of U.S. patents, trademarks, and copyrights--especially with such serious offenders as Taiwan, Singapore, and South Korea. Our latest GSP Review assured that the benefits of duty-free import treatment would remain directed toward those nations most in need of special consideration.

Bilateral Initiatives

The Administration has undertaken a series of discussions with major trading partners designed to improve the ability of U.S. exporters to realize their market potential. We have made significant progress on several fronts. We have been especially active in improving the environment for U.S. products in the Japanese market. The Market-Oriented Sector-Specific (MOSS) talks with Japan in five major sectors have achieved a reduction in discriminatory barriers against imports from the United States (and other countries). We look forward to continuing access to these sectors. We continue to be hopeful that Japan will fully comply with the provisions of our Semiconductor Agreement so that the remaining U.S. tariff increase can be rescinded. In addition, the Administration continues to expect that the Japanese Government will make additional purchases of U.S. supercomputers consistent with the competitive position of U.S. products.

The Administration also expects to achieve a successful conclusion to our negotiations with Canada for a Free Trade Agreement. Canada remains our largest individual export market and such an agreement should significantly expand our potential for exports to our northern neighbor.

Sectoral Initiatives

Several initiatives in the recent years have been designed to protect the viability of sectors critical to U.S. security and related economic interests. The Administration implemented controls on machine tool and steel imports designed to stabilize industries vital to our overall defense and economic capabilities. We continue to discuss with major trading partners their policies that adversely affect the competitive position of U.S. producers of telecommunications equipment and commercial aircraft. The United States is no longer in a position that allows us to ignore foreign commercial policies that put U.S. suppliers at a significant disadvantage.

WHAT REMAINS TO BE DONE?

The most important challenge we face today is an orderly narrowing of global trade imbalances--U.S. deficits and trading partners' surpluses--while maintaining U.S. and global economic progress. How we respond to this challenge will largely determine where the United States--and the global economy--stand at the end of this century, and the prospects for future generations.

The United States Government cannot legislate improved domestic and international economic performance. Attempts to do so would likely be counterproductive. It can, however, take steps that will help improve the domestic environment for developing more competitive U.S. industries. And through trade policy actions, it can affect the international environment in which U.S. businesses must compete.

The Administration's longer-term strategy to narrow our trade deficits and to improve the domestic and international economic environment for U.S. business centers on:

- o Major efforts to reduce excessive federal spending;
- o Continued aggressive implementation of existing U.S. trade laws, with some limited changes that would enhance their effectiveness;
- o Successful completion of the Uruguay Round and other market opening measures; and
- o Improved macroeconomic policy coordination with our trading partners.

Let me briefly touch on each of these areas.

Reducing Excessive Federal Spending

Our foremost priority is to bring the Federal budget deficit down. This will reduce the need for foreign capital to finance the gap between domestic U.S. saving on the one hand, and private investment and the government deficit on the other. The savings-investment gap has been the fundamental factor in the growth of the U.S. trade deficit. Reducing excessive federal spending is paramount for reducing the trade deficit.

Aggressive Implementation of U.S. Trade Laws

The Administration will continue its aggressive program of enforcing our trade laws. We will pursue negotiations with our trading partners whose policies and practices have impeded the ability of our exporters to realized foreign sales of competitive products. We will investigate and act on foreign subsidies and other practices that put U.S. producers at an artificial competitive disadvantage.

The Uruguay Round and Market Opening Measures

Launching of the Uruguay Round in September 1986 represented a significant step to improving the international economic environment for U.S. business. The United States is committed to successful conclusion of these negotiations because we believe that an improved GATT system is critical if U.S. products and services are to have unimpeded access to markets abroad.

Our free trade agreement talks with Canada are closely related to our Uruguay Round efforts. We have an opportunity with the Canadians to develop rules governing new areas of trade, such as services and protection of intellectual property, which could serve as models for the multilateral arrangements we would like to develop during the Uruguay Round talks. Both sides have a clear understanding of the issues and the difficult task ahead of us is to draft specific language, reconcile differing views, and tackle specific sensitive issues.

The Administration's long-term strategy also calls for continued aggressive efforts to open foreign markets so that our full export potential can be realized. Future initiatives when warranted can be expected along the lines of our MOSS talks with Japan, the market access talks with Korea and Taiwan, and the Market Access Fact-Finding consultations on telecommunications issues with several European Governments. The United States is also committed to negotiating a bilateral commercial framework agreement with Mexico that will guide our trade and investment relations with Mexico and to establish a consultative mechanism to resolve bilateral disputes.

Macroeconomic Coordination Efforts

Macroeconomic factors--the differing policies and performances of individual national economies--have been a major cause of our current trade deficit. There is a need for greater international coordination in correcting the global trade and payments imbalances, and the Administration is placing high priority on strengthening such coordination. We need to improve cooperation with our major industrialized trading partners along the lines agreed at the recently concluded Venice Summit. We also need better cooperation from the rapidly industrializing LDCs as well as from other debt-strapped LDCs who are progressing less rapidly.

We will continue to push our major trading partners on stimulating their economies. The recent stimulation package announced by Tokyo is encouraging and we expect the Japanese to fully implement their plan to increase their economic growth and their level of imports. Japan is one of several countries that must move away from growth derived from enlarging export surpluses and toward more domestically-generated growth. In addition, Tokyo must take a greater responsibility for global trade performance--a role commensurate with its economic strength and status as a world economic power.

The countries of Western Europe--especially West Germany and the United Kingdom--must boost internal growth as well as make structural changes in their economies that will foster sustained non-inflationary growth. Along with Japan, Western Europe must contribute more towards powering world economic growth.

Likewise, the rapidly industrializing nations of Asia--the NICs--must assume new responsibilities in world trade commensurate with their economic progress. They are among the major beneficiaries of the open international market system that has evolved since World War II. Realistic policies to open their markets must be adopted as well as undertaking measures to reduce their reliance on growth from export surpluses. Included is the need to move away from using managed exchange rates that foster large, unsustainable export surpluses. The United States will continue to encourage them to pursue policies more appropriate to their long-term progress and to that of the global economy.

We will continue to encourage the LDCs to increase their response to the Baker Plan's call for economic reforms that will motivate additional lending to them. Resolution of the debt problem and their long-term progress requires that they open their markets to private investment and adopt policies that will lead to stable, non-inflationary economic growth.

In Conclusion

Finally, Mr. Chairman, we will continue to press for trade legislation that enhances American competitiveness, increases U.S. leverage in our international negotiations--particularly the Uruguay Round--and avoids shooting ourselves in the foot by provoking retaliation and mirror legislation by our trading partners.

As you know, the Administration continues to urge the Congress to pass a bill that the President can sign, and has expressed a number of strong reservations regarding the package that is now emerging in the Senate. In the coming weeks, I urge the members of this Committee to work with your colleagues to fashion a bill that is responsible, signable, and truly in the national interest.

Thank you Mr. Chairman.

Senator SARBANES. Thank you very much, Mr. Secretary.

Mr. Secretary, I want to ask some opening questions prompted by that chart, which deals with net international investment position and which reflects an incredible deterioration in the American position from 1982 through 1986 when we went from about a plus $150 million to a minus $270 million. That's the descending line on that chart.

The other two lines show the net international investment position of Japan and Germany.

First of all, what factors in your view explain the deterioration in 1982–86 in our net position?

Secretary BALDRIGE. First, Mr. Chairman, the whole world was, I believe, surprised to see in 1981 and begin to realize as they studied it that the United States was actually going to cut its inflation rate. And given our reputation and past performance as a safe and secure place to invest, we attracted investment initially on that account.

The investment kept on coming in the years later because our real interest rates stayed above those of most of our other trading partners, other major economies in the world, and a combination of the fact the United States was an attractive place to invest and the real interest rates were high kept those funds coming in and we were able to finance these large deficits.

We are dependent, as I have said, too much now on foreign investment. At some time in the future, no one knows exactly when, but at some time in the future, our debt could get so large that we would not be an attractive place to invest and if those foreign investors went someplace else we would be in a position of having to raise interest rates to finance our deficit.

So it's very important for us to get it down, but the reason I think for that net investment position is very clear. Money from abroad found a very happy home here with high real interest rates and the determination of the Americans to keep inflation down and provide a good investment climate.

Senator SARBANES. You don't think that deterioration in position had anything to do with the deterioration in our merchandise balance? It seems to me directly related.

Secretary BALDRIGE. Oh, yes.

Senator SARBANES. We went from minus $36 million in 1982 to minus $67 in 1983 to minus $112 in 1984 to minus $124 in 1985. It seems to me that there is a direct correlation between the deterioration of that position and the deterioration in our net merchandise position.

Secretary BALDRIGE. Yes, they are two halves of the same circle, however you want to put it. I didn't mean to imply that there was no relation there. I thought your question addressed why foreign funds were so available in the United States. We wouldn't have needed them if we hadn't had that merchandise trade deficit.

Senator SARBANES. And why did we have that?

Secretary BALDRIGE. We had that because of our Federal budget deficit. I think that's the first reason, the largest reason.

Senator SARBANES. You think that's more of a reason than the overvaluation of the American dollar?

Secretary BALDRIGE. Again, that's part of the same. The reason that the dollar became so strong was because our real interest rates were high and that came about because of the Federal budget deficit and expectations for the future.

Senator SARBANES. How did the dollar decline so rapidly even whth the continuing high deficits, if the connection is that direct, over the past 2 years? For the past 2 years we've run large Federal budget deficits and yet the value of the dollar has changes markedly.

Secretary BALDRIGE. Yes, sir, but those shifts tend to overshoot the mark. We saw the dollar get so far out of line on the high side that it was beginning to correct itself in the international markets even before the Plaza meeting in December 1985. The decline of the dollar began in February 1985 and has continued since then.

Senator SARBANES. What is your prediction for the 1987 current account deficit? What do you predict it will be for the current year?

Secretary BALDRIGE. Well, if I were forced to make a prediction, I would way we would be $20 billion better off, less of a current account deficit.

Senator SARBANES. Of course, that means that our debt would grow at about a 50 percent annual rate over the previous year, is that right? That would represent at least a 50 percent increase?

Secretary BALDRIGE. Fifty percent increase in our debt?

Senator SARBANES. In addition. We have $260 billion in external debt. If we run another $130 billion, that would be a 50 percent increase. The point I want to try to develop is that while the current account deficit is not as large as it was the previous year, it is still adding significantly to our external debt, is it not?

Secretary BALDRIGE. Yes, that's true, Mr. Chairman, but I think that it's not a very clearcut use of the English language to call the net international investment position our international debt.

For example, if you look at the direct investment in the United States and then the direct investment by U.S. companies abroad, as far as equity goes, we are ahead of the game. We get more in payments from abroad by far then we make in payments abroad. If you took the receipts of payment overall on the international accounts, we are running in 1986 a $20 billion surplus. That's because our direct investment abroad pays us a lot more than the foreigners' investment in the United States pays them on direct investment. I'm talking about companies, businesses and so forth.

Senator SARBANES. Well, now, Mr. Secretary, let me ask you this. If we continue to run these current account deficits because of the trade imbalance, at what level do you think the external debt will top out? I have seen some estimates in the press as high as a trillion dollars.

Secretary BALDRIGE. Well, first, if I may go back to that last question for a minute, when we talk about the net international investment, that is not all debt. That was the point I was trying to get across and perhaps didn't in my last answer. A lot of that are equity investments in the United States. I don't look on them as debt. I don't think most businessmen would either. Now obviously there are a lot of financial instruments, bonds and so forth, that are straight debt. But I just wanted to make that point.

In answer to your second question, no one knows. Again, if I had to make an estimate, I would say sometime in the early 1990's we would come to an evening out of our merchandise trade deficit that would bring that current account balance down to somewhere around zero or maybe even a plus.

I say that because it's not hard at all, Mr. Chairman, to predict that we are going to work toward in the next few years a zero merchandise trade deficit. I think that is clearly baked in the cake. It's an economic fact of life. We cannot continue to run these kinds of deficits with the rest of the world running surpluses.

The real question is, how do we arrive there at reducing the merchandise trade deficit to zero? If we follow the wrong macroeconomic policies, if we run into a situation worldwide where we are in a recession and the rest of the world is, we will see the dollar plunge far enough, just as an economic rule, so that we will get our trade deficit to zero by having the dollar go down and that will greatly lower the standard of living if we have to do the whole thing on that basis—lower the standard of living for Americans.

If, on the other hand, we increase our productivity and take the right macroeconomic steps as a country, our businesses get more competitive as they are doing, that trend continues, we will be able to reduce the merchandise trade deficit to a zero figure and increase our standard of living. And that latter point is the way we want to get there.

But either way, we will get to somewhere close to zero on our merchandise trade deficit because the international economy simply cannot stand what we see going on now with those surpluses in the countries that I mentioned as an example.

Senator SARBANES. Mr. Secretary, my time is up. Let me just close with this observation. I am extremely concerned that we have allowed this trade situation to deteriorate so severely and have accumulated such a significant external debt. The debt will continue to grow even if the trade situation improves year to year until we actually move to a positive balance; at that point only can we begin to reduce the overhang of the debt. In the meantime, the carrying charge on that debt is obviously growing, thereby exerting a demand on American production and an impact on the American standard of living. There's no measure of our ability to service the debt that is growing at anything approaching a rate comparable to the growth in the debt that has to be serviced. In other words, the increase in the GNP is nowwhere near the growth in the debt, so it is becoming a larger burden, not smaller. And it gives every sign of continuing to do so over the near future at least, the next few years in any event.

It seems to me that in a sense we face an impending crisis. If you look at what we have to do in the merchandise trade area to turn this thing around, we're really being called upon for an extraordinary performance. And in your statement you even made the point that other countries are doing everything they can to hold onto their market share, including taking apparently very severe cuts in profit margins and all the rest of it.

So I find it a situation of extreme concern and I may come back to it in a second round.

Congressman McMillan.

Representative McMILLAN. Thank you, Mr. Chairman.

Mr. Secretary, I apologize for being a little late and I add my welcome. I appreciate you coming over.

We talked a good bit about the same issue yesterday and got into the question of the characterization and the source of the net foreign investment rather than characterizing it as truly debt. As you rightly said, a lot of that is equity investment attracted to this country derives from investment capital around the world. That capital contributes to economic development, and that's positive. There's nothing negative about that.

On the other hand, I would be concerned if we became dependent on foreign capital as such, for an overextended period of time, and if our net external debt continued to accumulate. That would be alarming.

But I am equally alarmed about the continuing accumulation of Federal indebtedness as a result of our budget deficit. We are running a deficit at a rate of $180 billion a year, which is far greater than the increase in our net external borrowings or investment position last year. I would submit that that Federal budget deficit contributed importantly to the need to look outside the United States for funds. And that's one of the places where it seems to me the Federal budget deficit relates directly to our international debt position and where also the issue of the trade deficit and the budget deficit come into congruence in terms of the priorities it places upon us to deal with them.

But translating that a little bit further into policy—and I do think policy is an issue that we should be addressing—did I hear you say that you do at this point believe it is a desirable policy for the United States to pursue balance in its trade position?

Secretary BALDRIGE. Yes. Mr. Congressman, we are going to get to a balance, without question. The only question, as I said, is how we get there. If we get there with the wrong policies that cause a large decline in the dollar and balance our figures that way, we will definitely lower our standard of living.

On the other hand, if we can increase our productivity and get competitive that way so that we could keep the dollar at a reasonable level, we will have a higher standard of living.

In short, the higher the dollar is and that we can balance our international accounts at the same time—the higher the level of the dollar that we can do that at, the higher standard of living there will be for the United States. So that's what we ought to strive for.

But one way or the other, we are going to end up with a close to balance on merchandise trade.

Representative McMILLAN. Well, if we, for example, had a healthy growing economy, and had achieved more or less balance in our international trade accounts, I wouldn't find it at all disturbing if we were attracting an additional $100 billion a year in investment capital into this country in the form of equity investments. I think that's healthy.

Secretary BALDRIGE. Particularly if it goes into the kinds of capital investment that provides jobs here.

With all of the figures that we see on net international investment, whatever it's called, we're a net debtor around the world and

so forth—we hear that all the time—I'd like to point out if I may that if you took all of the payments that we have to make on that debt and put against them the receipts that we get from the same kinds of things abroad, we are in a net surplus position. Last year, $20 billion. We received more from the kinds of investments we had abroad, $20 billion more, than the foreigners received from us. Now that's a long way from going broke on something like this.

Representative McMillan. So, again it really gets back to the character, or the makeup, of that net investment position and if we are basically borrowing—if it consists principally of an inflow of dollars to buy short-term Treasury bills to fund the U.S. budget deficit, then that's not healthy. If it's in the form of long-term equity commitments to the American economy that create jobs, then that's positive. So I think you have to look at it in that light.

Secretary Baldrige. We have about $260 billion of direct investment abroad, the United States does, and foreigners have about $209 billion invested here in direct investment—factories and that kind of thing—but ours has been there a lot longer than theirs and if we were to mark those up to market value—they're on at book value now as the initial investment—if we were to mark our assets up to market value today because they have been there longer than foreigners have here in this quantity, we would see an even greater disparity between the kinds of investment.

Representative McMillan. I would simply like to make one other observation. You and I have discussed on many occasions the trade issue and the legislation now pending before the Congress and I think we obscure the challenge we face in world trade when proponents on either side of that issue—free traders and protectionists as they are called—simply rest their cases on those labels. In fact, you and I know—all of us know—that world trade largely exists under a set of agreements. And so long as there is an agreement, in contrast to a free market system, there's a degree of protection in there. Otherwise, there would be no need for the agreement.

So I wish we would quit labeling—I'm not accusing you of this because I think you're very reasonable in this approach—everything that deals realistically with the realities of world trade as protectionist, when, in fact, we know we basically have to negotiate not only in the interest of promoting world trade but, also in our own self-interest of achieving a desirable result. So balance in world trade in not just a problem of the right value of the dollar. It is going to consist of negotiation. I simply wanted to get that point in the record.

Secretary Baldrige. Well, Congressman McMillan, one of my political friends told me that when the Democrats take a trade action it's protectionistic; when the Republicans take a trade action it's realistic, so——

Representative McMillan. That sounds realistic. [Laughter.] Thank you, Mr. Secretary.

There is one other question I want to get on the table—and maybe we can come back to it if I run out of time—because I think it is a rather far-reaching question. It has a tremendous bearing upon not only our domestic budget deficit but also on the payments balance.

For the last 40 years, the United States has assumed a leadership position in the world that calls upon it to make capital commitments worldwide, which we have done, both through foreign assistance and through the private sector. This leadership position also calls upon us to take the lion's share of the cost of the defense of the free world. It has been built into our mind set and so we find ourselves in 1986 spending 6.8 percent of our gross national product on defense. Meanwhile, our major allies—and I emphasize that word "allies" because I'm not being critical of them to spend far less. Many of them do assume tremendous burdens, but the NATO nations in the aggregate probably assume a level of defense expenditures of only 3.5 percent of gross national product; the Japanese assume a level of 1.0004 percent of gross national product. The Japanese ecomony is very powerful. The Western European economy is very powerful in the aggregate.

It seems to me that the time has come for the United States to begin to look to our allies to assume a greater proportion of the cost of providing for common defense and foreign assistance as well. This should be a very basic policy. This is very much related to solving the problems of the budget and of the trade deficits in this country.

If we could come back to this later—I think I've run out of time—I would appreciate any comments that you might have on that, Mr. Secretary.

Secretary BALDRIGE. Well, I would just say briefly that I think the common sense in what you say is undeniable. How we get there and what we do to get there is not within my province to say in my particular position, but the more we spend on defense, the less we can spend on research and development and investment in new facilities and so forth. That's very clear.

Senator SARBANES. Senator Bingaman.

Senator SYMMS. Mr. Chairman, could I make a unanimous consent request?

Senator SARBANES. Surely.

Senator SYMMS. Mr. Chairman, thank you very much. I ask unanimous consent that my opening remarks be inserted in the record. And I apologize to the Secretary that I can't stay this morning. I have another meeting.

Senator SARBANES. Thank you very much. The remarks will be included in the record at this point.

[The opening statement of Senator Symms follows:]

OPENING STATEMENT OF SENATOR SYMMS

Let me join with Chairman Sarbanes in welcoming this morning's distinguished witnesses who will be testifying before the Joint Economic Committee (JEC) on the role of the United States in the global economy. My special regards go to our estimable Secretary of Commerce Malcolm Baldrige who has always given a superb account of himself before us.

A mid-year examination of America's international economic performance strikes me as an especially timely focus. Over the past few months, the U.S. trade balance has begun to reverse itself. A depreciated U.S. dollar is already helping to boost exports. In volume terms, American nonagricultural exports actually rose by 5 percent in 1986; by the fourth quarter of last year they stood 9 percent above the level of the previous fourth quarter. Improvements are even seen for the long embattled agricultural sector with the U.S. Department of Agriculture projecting a 15 percent increase in the volume and a 5 percent increase in the value of agricultural exports this year over last year. Commenting on future U.S. trade prospects before this Committee yesterday, CEA Chairman Beryl W. Sprinkel hit the appropriate note when he said that, "We can be very confident about the direction of change". I agree.

The United States has been an engine of world economic growth over the past 6 years--sucking in equivalently large volumes of imports from the rest of the world. Though we are in the 55th month of domestic expansion, import growth has clearly slowed. For our major trade partners, this means a larger role for them in stoking global recovery over the remainder of this decade and beyond.

This message has had a hard time getting through to the right people in Tokyo, Bonn, and other major allied capitals. But even they are beginning to respond to market signals. Japan, for example, has committed itself to a $43 billion domestic stimulus package. It has also promised to expand its lending to Third World countries. Both actions are long overdue. They are no less encouraging portents of a more outward reaching Japanese policy toward the global economy--from which they have so richly benefitted. I am confident that other major allied countries will follow.

External account balances aside, however, the world will continue to rely on the United States for global economic leadership. How could it be otherwise? We continue to preside over the largest, most innovative economy. Since the end of World War II, the U.S. has taken the lead in establishing the major multilateral institutions that determine the health of the international trade and payments system--the World Bank, the International Monetary Fund, and the General Agreement On Tariffs And Trade. For the U.S., the challenge will be to encourage a more sensible division of labor between the United States and its Asian and European partners in a manner which promotes trade growth. In view of strong protectionist tendencies throughout the world, this will not be an easy task for the U.S. It is a necessary and worthy one. On this note, I once again welcome our witnesses to the Joint Economic Committee. I look forward with pleasure to their testimony.

Senator SYMMS. I want to welcome our distinguished witnesses today. This hearing is a very important one because of the current trade bill debate on the floor of the Senate. Perhaps some of the comments here will be used later today or next week in that debate.

Yesterday, Beryl Sprinkel appeared before this committee and commented that the proposed tax increase in the congressional budget resolution may have a depressing effect on U.S. economic performance later this year and in 1988.

I also noticed in the newspapers that the World Bank has just published its annual World Development Report. One of the report's most pertinent findings in my view is that if the nations of the world continue on a path of monetary and fiscal imbalance with large domestic budget deficits and high taxes and if we continue to plunge into world protectionism, we could seriously reduce economic growth.

During the hearing today, I would like each of the witnesses to address these issues of how we are going to stimulate economic growth instead of stifling it.

In particular, I hope the witnesses can be as specific as possible about some of the trade restrictions that are presently being debated on the floor of the Senate, so their expert analysis might be used to help us do the best thing with this trade bill.

Senator SARBANES. Thank you very much, Senator Symms.

Senator Bingaman.

Senator BINGAMAN. Mr. Secretary, welcome. I have another chart that I would like your thoughts on.

This chart was prepared by the Committee on Economic Development and is entitled "Deepening Net U.S. International Debt: A Best Case Versus a Business-as-Usual Case." It comes from a report that they are issuing in the very near future.

The chart points out that if we pursue business-as-usual and the current account deficit remains very large, we would have a very significant deepening international debt.

The point you have made two or three times this morning is that the trade deficit will be reduced to zero, and it's just a question of how that happens, whether it happens because of lower standard of living because the dollar continues to drop or whether it happens because of increased productivity. Is that accurate?

Secretary BALDRIGE. What will happen, sir, is if our debt gets to some point—no one knows just where—where foreign investors begin to worry more about what's going to happen next in the United States than they are worried about investing in some other place whether it's the U.K. or the European Community or somewhere in South America, if this scene that you have here were to be laid out at some point before it got to the bottom, it's my belief that foreign investors would back away, the would look on this country now as not worth the risk and we would have to increase interest rates greatly to attract the kind of money to pay off our debt, and that would cause the kind of recession that would—we would clearly end up with a lower standard of living, a lower dollar, that would in effect hurt us. We don't want to do that.

But what would have caused the problem would be outside investors, foreign investors, looking at any point here along this line and say, "It's safe for me to invest my money someplace else."

Senator BINGAMAN. I guess what concerns me is when I look at the trade deficit and current account deficit I have difficulty seeing how we are going to get that back to a balanced position. This will be especially difficult given the fact that our imports of foreign oil are going up. Oil imports are projected by the Department of Energy to continue increasing in the next 5 to 10 years and really there's no point at which they are expected to turn down that I'm aware of.

Secretary BALDRIGE. Mr. Bingaman, your question was how is this going to happen, how are we going to get an improvement and an increase in the standard of living. Honest and truly, most observers don't fully grasp the strides that American business have made in becoming more competitive. I have to see it and live with it all the time in my job. I see company after company that have cut their costs, not 5 percent or 6 percent, they have cut them by 30 percent. I mean their total costs across the board. They have a break-even point 25 or 30 percent lower than they did in 1980. They have done it not because they are that much better than anybody else but because they have had to. They had to exist in this cutthroat global competition. Our companies are getting leaned down. Their quality has gone up by a factor of four or five—not perfect, not every company, but I would say most companies have been through this process. So right now they are at the best trim to be competitive that they have been for a long, long time.

And at this time, we've seen our dollar go down against the other major currencies and that is already affecting in a major way the volume of imports and exports to the United States. Our exports are up 17 percent from last summer to this summer.

Senator BINGAMAN. I agree with a lot of what you're saying, but is it your prediction that U.S. manufacturing will be able to export enough in excess of what's imported in manufactured goods and products to compensate for all that we have to import in oil and petroleum products?

Secretary BALDRIGE. It would be a two-edged sword on the way down for the deficit like it was on the way up. Yes, to your question about manufacturers. We will be immensely more competitive and that will show up on the export side. But also, yes, to decreased imports because if you think about it 75 percent of all the goods sold in the United States now are subject to intense foreign competition and if American manufacturers are able to compete abroad they certainly ought to be able to compete in this country. That's the message I keep bringing around to people in Keokuk, Iowa, and Brent, Kansas, and so forth, the small manufacturers there. You're already competing, I tell the U.S. people. You are already competing against foreign imports, so you might as well export and compete against them. That's to get exports up. But we will see lower imports. We are already seeing in volume, not in unit price, 2.5 percent drop in imports over the last 6 months and that's not much but imports are stubborner. They keep on hanging in there longer. But we will see both happen—increased exports and decreased imports.

Senator BINGAMAN. We've seen an improvement in the relationship of the dollar to the yen and the mark. But we have not seen an improvement with respect to the currencies of some Third World countries, particularly in the Pacific Basin and Canada.

It seems to me it may not be as large a problem as the yen-mark problem, but it is clearly a persistent obstacle to us dealing with this trade deficit. What is being done to solve that problem?

Secretary BALDRIGE. You are absolutely correct. We can't solve the exchange rate or come close to solving the exchange rate difficulties with the Japanese and the Germans and the U.K. and then allow the Taiwanese and the South Koreans and Hong Kong to walk away with whatever the advantages were we gained. We've made that very clear to Taiwan and South Korea. In the case of Hong Kong, their market is so open that it's hard to find much in the way that we ought to criticize or ask them to change.

In the case of Taiwan, their foreign reserves are up to almost $60 billion now. I think that's only exceeded by Germany and perhaps Japan. I think there are only two countries in the world with more foreign reserves than Taiwan has. Yet they are not moving that surplus. They are not regenerating it and investing it.

We think that they should strengthen their currency. We have told the South Koreans that, too. The South Koreans, we will see a favorable change in our deficit with South Korea beginning sometime this year. That will change and go the other way because of some actions they have taken. But Taiwan has still not stepped up to that problem enough of the international exchange rates. They have done it some but not enough.

Senator BINGAMAN. Aren't there some things we can do besides just talking to them about this? Isn't there some leverage that we can bring to bear on the Taiwanese and the South Koreans to get this currency valuation problem fixed?

Secretary BALDRIGE. Well, I suppose there is, and I know in times like this particularly we want to get speedy action on a serious financial problem like that or else look for sanctions or something. The fact is, it's more of a gradual process. In the case of Taiwan, they have to their credit reduced thousands of tariff barriers to our goods going in there. They are going to reduce some more. We keep talking to them about strengthening it by 20 percent. It isn't enough, so we will have to keep on talking. But I think it's a wrong thing to try and just use sanctions immediately when they don't do exactly what we want in exactly the same timeframe. They have been moving and we would like to see them move faster, but it hasn't been a disaster by any means.

Senator BINGAMAN. Thank you, Mr. Chairman.

Senator SARBANES. Congressman Fish.

Representative FISH. Thank you very much, Mr. Chairman, and my compliments to you for holding this important hearing. I take particular pleasure in welcoming my friend, the Secretary of Commerce, who is a major player in advancing U.S. trade policy—the most recent step being the action the Secretary took with respect to export controls which I thought was exemplary, as well as courageous.

Mr. Chairman, I had, had I been here promptly, an opening statement. I ask that that be made a part of the record.

Senator SARBANES. Certainly. Without objection, so ordered.

[The opening statement of Representative Fish follows:]

OPENING STATEMENT OF REPRESENTATIVE FISH

I AM PLEASED TO HAVE THE OPPORTUNITY TO JOIN WITH MY COLLEAGUES ON THE JOINT ECONOMIC COMMITTEE IN WELCOMING TODAY'S DISTINGUISHED WITNESSES. I TAKE PARTICULAR PLEASURE WITH REGARD TO OUR LEAD OFF WITNESS, U.S. SECRETARY OF COMMERCE MALCOLM BALDRIGE WHOSE DEPARTMENT HAS PLAYED A MAJOR ROLE IN ADVANCING U.S. TRADE POLICY. WELCOME MAC. BECAUSE WE HAVE A NUMBER OF PEOPLE TO HEAR FROM THIS MORNING, I WILL KEEP MY OPENING STATEMENT BRIEF.

THE SUBJECT OF TODAY'S JEC HEARING IS THE EVOLING U.S. ROLE IN THE GLOBAL ECONOMY. THIS IS A VITAL ISSUE FOR THE UNITED STATES. APPROXIMATELY 5 MILLION AMERICAN JOBS PRESENTLY DEPEND ON EXPORTS; OVERALL, BETWEEN ONE-FIFTH AND ONE-QUARTER OF OUR GROSS NATIONAL PRODUCT (GNP) IS GENERATED THROUGH INTERNATIONAL MERCHANDISE AND SERVICE TRANSACTIONS. THIS PERCENTAGE WILL, IF ANYTHING, GROW. AND AS WE HAVE RECENTLY SEEN WITH RESPECT TO INTERNATIONAL MONETARY POLICY, WEST GERMAN AND JAPANESE DECISIONS TO RAISE OR LOWER DOMESTIC INTEREST RATES INVARIABLY HAVE A DIRECT IMPACT ON THE DOLLAR'S EXCHANGE RATE VALUE. IN SUM, WE HAVE NEVER BEEN SO DEPENDENT ON THE GLOBAL ECONOMY AS WE ARE TODAY.

NOWHERE IS THIS DEPENDENCE MORE PRONOUNCED THAN IN THE FIELD OF INTERNATIONAL TRADE. FOR A GROWING NUMBER OF AMERICAN FIRMS, SUCCESS OR FAILURE DEPENDS ON HOW EFFECTIVELY THEY COMPETE FOR SALES WITH THEIR JAPANESE, EUROPEAN, AND THIRD WORLD COUNTERPARTS--BOTH ABROAD AND AT HOME. AND THIS IS AS IT SHOULD BE. TRADE REMAINS THE MOST IMPORTANT GROWTH CATALYST

IN THE WORLD ECONOMY. SINCE 1945, COMBINED WORLD EXPORTS AND IMPORTS HAVE ACCORDINGLY GROWN BETWEEN 1 AND 2.5 PERCENTAGE POINTS FASTER THAN GNP. THIS IS BECAUSE TRADE EXPANSION GENERATES DOMESTIC GROWTH BY FREEING RESOURCES AND STIMULATING PRODUCTIVITY, WHILE OPENING MARKETS FOR THE EXPORTING COUNTRY.

I WOULD LIKE TO END ON THIS NOTE. BUT I KNOW THAT OUR WITNESSES HAVE SOME ADDITIONAL, AT TIMES DISTURBING POINTS TO MAKE ON THIS VERY SUBJECT. THOSE POINTS DIRECTLY INVOLVE AMERICA'S GROWING MERCHANDISE TRADE DEFICIT WITH THE REST OF THE WORLD OVER THE PAST DECADE, AND WHAT THOSE IMBALANCES MEAN FOR THE DOMESTIC AMERICAN ECONOMY. WE HAVE CLEARLY REACHED A CRITICAL JUNCTURE IN THE TRADE ARENA. BETWEEN 1981 and 1986 U.S. IMPORTS EXCEEDED U.S. EXPORTS BY NEARLY $600 BILLION. AT LEAST FOR THE FIRST FEW YEARS, THIS WAS NOT AN ENTIRELY UNWELCOME DEVELOPMENT. WITHOUT THIS LEVEL OF AMERICAN IMPORT DEMAND, THE WORLD RECESSION WOULD PROBABLY HAVE BEEN UNDULY PROLONGED. AND IMPORT COMPETITION CERTAINLY HELPED AMELIORATE DOMESTIC U.S. INFLATIONARY PRESSURES. BUT THIS DETERIORATION IN OUR MERCHANDISE TRADE ACCOUNT HAS CLEARLY GONE FAR ENOUGH. NEITHER WE NOR THE REST OF THE WORLD WILL CONTINUE TO BENEFIT FROM THIS HUGE IMBALANCE EXISTING BETWEEN THE UNITED STATES, ON THE ONE SIDE, AND ITS EUROPEAN AND ASIAN PARTNERS, ON THE OTHER SIDE. THE QUESTION FACING US TODAY, THEN, IS NOT WHETHER WE ESTABLISH GREATER BALANCE IN THE U.S. EXTERNAL ACCOUNT--BUT HOW WE GO ABOUT DOING IT, AND WITH WHAT CONSEQUENCES FOR THE UNITED STATES AND ITS TRADE PARTNERS. I DO NOT PRETEND TO HAVE FINAL ANSWERS TO THESE ALIGNED QUESTIONS, BUT TWO CONSIDERATIONS SEEM CRUCIAL

TO ME.

FIRST, THE UNITED STATES CLEARLY NEEDS TO UNDERTAKE A LONG TERM INITIATIVE DESIGNED TO HELP IMPROVE AMERICAN TRADE COMPETITIVENESS. "COMPETITIVENESS" HAS, TO BE SURE, BECOME A SYMBOL AND A FAD--EXPRESSING AS IT DOES, A VARIETY OF U.S. CONCERNS ABOUT AMERICA'S FUTURE PLACE IN THE GLOBAL ECONOMY. CONGRESS'S JOB IN MY VIEW IS TO SHARPEN OUR DEFINITION OF THIS CONCEPT IN ORDER TO FOSTER THE KIND OF DOMESTIC ENVIRONMENT HERE IN THE UNITED STATES WHICH LEADS TO A MORE ROBUST POSITION FOR AMERICAN FIRMS IN GLOBAL MARKETS, INCLUDING OUR OWN.

WE HAVE MADE SOME PROGRESS IN RESTORING U.S. COMPETITIVENESS: THANKS TO THE DOLLAR'S DEPRECIATION SINCE LATE 1985 AND JUMPS IN MANUFACTURING PRODUCTIVITY. THESE TWO WELCOME DEVELOPMENTS SHOULD HELP PROVIDE THE UNITED STATES WITH RENEWED OPPORTUNITIES TO EXPAND SALES OF U.S. GOODS AT HOME AND ABROAD. TO REALIZE THESE GAINS, HOWEVER, REQUIRES MORE FUNDAMENTAL, STRUCTURAL SHIFTS IN HOW WE POSITION OURSELVES IN THE GLOBAL ECONOMY. I WOULD EXPECT THIS MORNING'S WITNESSES WILL PROVIDE US WITH SOME NECESSARY INSIGHTS INTO HOW WE GO ABOUT ACCOMPLISHING THAT SHIFT.

SECOND, WE CLEARLY NEED TO PRESS FORWARD IN NEGOTIATING MORE EQUITABLE RULES FOR CONDUCTING INTERNATIONAL TRADE. THE WORLD HAS CHANGED DRAMATICALLY OVER THE PAST DECADE. U.S. TRADE LAWS NEED TO REFLECT THOSE CHANGES; AS DO THE TRADE LAWS OF OUR PARTNERS. FOR INSTANCE, IN THE FIELD OF SERVICES--AN AREA WHERE I HAVE A GREAT INTEREST--U.S. FIRMS (FROM

INSURANCE TO TELECOMMUNICATIONS) CLEARLY REQUIRE FIRMER, I.E., MORE TRANSPARENT AND INTERNATIONALLY ENFORCEABLE, GUARANTEES FROM ADVANCED DEVELOPING COUNTRIES THAT THEY WILL BE ALLOWED TO COMPETE FAIRLY IN THEIR GROWING MARKETS. SIMILAR CONSIDERATIONS INVOLVE U.S. AGRICULTURAL EXPORTS. THE WORLD, NOT JUST THE UNITED STATES, DESERVES A FREER, LESS SUBSIDY LADEN, COMMERCIAL ENVIRONMENT FOR THE SALE OF COMMODITIES. FOR THESE ABOVE REASONS, IT IS IN AMERICA'S FOREMOST INTEREST TO EFFECTIVELY PUSH FOR MEANINGFUL BREAKTHROUGHS IN THE NEW GATT ROUND PRESENTLY UNDERWAY IN GENEVA.

NEITHER OF THESE ABOVE ACTIONS WILL, IN THEMSELVES, ANSWER ALL OF AMERICA'S TRADE CHALLENGES. BUT IF THEY ARE PROPERLY UNDERTAKEN, I HAVE NO DOUBT IN MY MIND THAT FUTURE U.S. TRADE PROSPECTS WILL BE BRIGHT INDEED.

Representative FISH. Mr. Secretary, to be very brief, it seems to me that one of our problems is how we go about establishing greater balance in the U.S. external account. This method involves you directly in terms of the need for long-term initiatives to improve American trade competitiveness. We are well aware of the many-faceted approach to which you have contributed and which was just discussed. We have to press forward in negotiating more equitable rules in the conduct of international trade.

So my question to you is: What in your judgment is the most significant action the United States can take now to improve future American trade prospects? Perhaps you would prefer to list actions that should be taken simultaneously rather than just name one.

Secretary BALDRIGE. Well, if I had to name one, it would be reduce the budget deficit. But obviously that can't be the sole answer. There are some other things, too.

And you would have to divide them, Mr. Congressman, into macroeconomic and microeconomic actions. I think under macroeconomic, we need to reduce the budget deficit and the trade deficit in tandem. They have to go down together if we're going to come out of this without having some kind of a recession. They have to go on concurrently.

If we're going to give our companies a level playing field, we need a successful completion of the Uruguay round of GATT. There are a lot of international trade practices that are not covered by the GATT that need to be if we're going to get a fair shake—services, agriculture, dispute settlement particularly. We have a good deal of you gentlemen and the Congress that look at GATT as a kind of week reed because the dispute settlement mechanism is weak and we need to change that.

All of those help our trading companies, exporters, sell abroad. We have to continue the kind of trade law implementation we've had in the last 2 years. We've been a lot stronger, a lot tougher in enforcing our trade laws than we were in the first 3 or 4 years. And we need those kind of fair trade laws to underpin our free trade policy because free trade constituency would just disappear if we didn't have fair trade laws and implement them.

I think we have to—becaue we are so interdependent now as a world—we have to improve our macroeconomic policy coordination with our major trading partners, the major industrial countries of the world. We are seeing the beginnings of having a lot more of that kind of cooperation than we did before. Certainly it has improved greatly since 1981, but we have to improve it even more because the world is getting more complex and complicated.

If we could wave—I was going to say wave a wand but that's not the right way to put it—we should develop policies and get them passed that would encourage savings in the United States so we're saving more and have more to invest. I'd encourage investments in education so that our kids are as good as any in the world for further training if they decide to go into manufacturing or whatever it is—they know how to read, they know how to write, they know how to synthesize an argument and so fourth because they've been trained in it.

So education and investment abilities because of the increase in savings, those are all macroeconomic kinds of things we can do.

Representative FISH. Thank you very much. Just a word on education because we all deplore the high rate of functional illiteracy in the country. Also, I think that while addressing it, we should be conscious of what has been referred to as "International illiteracy." Our children are coming out of school not having a knowledge of languages nor much about the history or culture of other countries—a knowledge which, for the competitiveness that you describe, we certainly need to have.

Secretary BALDRIGE. I wish we could have compulsory language in every school.

Representative FISH. Mr. Secretary, one other question. You played a major role in negotiations for improved market access in Japan. One crucial aspect of that policy involves the market opening sector specific talks with Tokyo. I've heard little about MOSS recently and I wonder if you could bring us up to date.

Secretary BALDRIGE. Well, the main areas were telecommunications, forest products, medical equipment and pharmaceuticals, and electronics. The net results have been—and I don't know if you could trace this exactly, but it's sure heading the right way—that we had a 13 percent increase in exports to Japan in all these MOSS efforts in 1986. I'm not going to sit here and claim that that was all due to the MOSS negotiations, but they certainly were a major factor in it.

In the telecommunications area, we were able to virtually eliminate all the regulatory barriers and discrimination in the telecommunications equipment and radio services area. However, we were not able to eliminate that reaction of the Japanese—on a one-time basis anyway—when the cable project from Japan to our West Coast came up—the KDD project it's called—that's the equivalent of our AT&T offshore—to have any competition for that. We are seeing some barriers that are put up in ways we hadn't seen before and I think we are getting them negotiated down, too, but that part has not come easily.

In forest products, we did win significant reductions in paper and wood tariffs and easing those barriers about standards to our wool panel product exports that were really silly but they were in there and they were hurting us and we were able to get them out. So we did get reductions there.

In medical equipment and pharmaceuticals, we greatly simplified the regulatory procedures and we eliminated a lot of the administrative delays. And our companies would say that. It's not perfect yet, but it's a lot better than it was.

In electronics, we leaned very heavily and were able to get extension of copyright protection to software and get elimination of tariffs on computers and parts. That software was very important. We worked very hard on copyright protection there because the Japanese were not going to give it copyright protection and were going to go another route with it. They didn't really want any protection at all because that's where they're behind is on software and we're ahead of them, and it was very important for us to get this copyright law through, which we did.

Before we started those talks, the Japanese were embarked on a policy on software that if the U.S company had licensed any Japanese company to use their software, then that company could li-

cense any other Japanese company. And that would have certainly killed any initiatives we had in that area. So that's a brief answer to your question.

Representative FISH. Thank you very much.

Thank you, Mr. Chairman.

Senator SARBANES. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

It's a great pleasure to have you back here, Secretary Baldrige, and we always benefit from your eloquent and informed testimony.

Let me ask you a sort of general question about the budget deficit. There seems to be a very nebulous component wherein we see no light at the end of the tunnel. Now over the last 6 or 7 years on actual appropriations the Congress has been within a percentage point or two of the President's budget. We may have changed the mix a little bit, but we have really ground in and reduced domestic programs very substantially. There's not much fat left there, little if any fat left there.

It seems to many of us that an answer must come from revenue enhancement. We have met the President's budget in our appropriations. We're virtually dollar-for-dollar with him.

If you accept that and if you accept the fact that we are going to have some revenue enhancement, as leaders of both parties have confirmed in the Congress, which of all the elements that have been described would you put together for the Baldrige package? Is it luxury tax, alcohol tax, tobacco tax, gasoline tax at the pump, gasoline tax at the border? Is it deferral of the decrease in corporate tax reductions? Is it deferral of individual tax reductions? Is it some kind of consumer tax, a value added tax, a national sales tax?

Which of all of the things that have been floated from all points of the spectrum would you say seem to make sense and that sooner or later the executive branch and the Congress are going to have to look at very closely?

Secretary BALDRIGE. Congressman Scheuer, I hope I can still keep your friendship, which I do cherish, and nimbly avoid that trap of saying which tax do you like if you had to take a tax.

First and foremost, we have to get government expenditures down. Now I know we are tighter than we used to be and that's been the result of some cooperation between the Congress and the President.

A lot in Congress think we've cut everything to the bone. I'd be glad to go into some areas that I think can be cut more.

Representative SCHEUER. Tell us.

Secretary BALDRIGE. EDA is one that comes to my mind right now. There's $200 or $300 million left in that.

Representative SCHEUER. $200 or $300 million is not going to make much of an impact.

Secretary BALDRIGE. I was taught the other way, Mr. Congressman. I've been down in Washington for 7 years and I still don't understand that kind of thinking, honest and truly: $200 or $300 million, that's a third of a billion or a fifth of a billion. That's the way you pick it up. You can't pick it up by one big chunk.

Representative SCHEUER. We remember what Senator Dirksen told us, "A billion here and a billion there, and pretty soon it adds up to real money."

Secretary BALDRIGE. Yes, but you know the way the Japanese were ahead of us for a while on quality and we're getting back now, it's incrementally. It's step by step. It's a jillion little steps. That's the only way in getting a budget down in a company for the 30 years I was able to do it. There's no one big thing. And that's the way it is here.

So I say when we have reached some kind of agreement that all the spending has been cut that can be cut—and literally there's some agreement on that—and then if we have a budget deficit of any size, I think the President would sit down and talk about revenue enhancement in whatever ways you want to do it. I know when the Republicans use it, it's revenue enhancement. When the Democrats use it, it's tax raising. That's the political jargon.

Representative SCHEUER. Mr. Secretary, you're talking about some incremental cuts at the margin and you probably could put together 10 examples of where you could pick up a quarter or a third of a billion. So you're talking about $2 or $3 or $4 or $5 billion, when we're talking about an annual budget deficit in the hundreds of billions of dollars. It's $160 billion now. Surely, you can do better than 3 percent of what we're talking about.

Secretary BALDRIGE. Well, what about the public works bill, Mr. Congressman, that just went through? What about the highway bill?

Representative SCHEUER. The public works bill—Mr. Secretary, one of the problems in this country is that our infrastructure is crumbling. We have water systems in New York City and New York State that go back to the last century, wooden pipes. Bridges are falling down. Cars are tumbling into the water because we are letting our infrastructure collapse. We can't turn off these programs that maintain our capital plant in this country. We've done a lot of that for the last 6 or 7 years, far too much.

We are in a desperate deficit position on capital plant. That's too easy and too glib an answer to say cut down on public works. I don't say there isn't a little reality to the concept of pork barrel. Of course there is. This is a human institution. But it's too glib and too easy an answer to make to say just cut down on public works. We are in desperate deficit in public works. We ought to be spending a great deal more on our roads, on our sewers, on our water systems.

Secretary BALDRIGE. Well, may I put it another way because I can see I touched a sore point there.

Representative SCHEUER. Well, I come from New York City where we have water pipes that go back to the 1800's which lose half the water that flows through them. There are other cities in this country that have a desperate need for vast infusions of money. If we did the job on our tertiary sewer systems, cleanup, that we urgently need, we would be spending billions of dollars more to produce clean lakes and clean rivers. And we've made progress. The Potomac and the Hudson are almost swimmable, but it's only because Congress in past years has spend vast billions of dollars to do that and there's a need for vast billions more to clean up our environment, to get rid of acid rain.

Secretary BALDRIGE. Could we look at the positive side for a minute, Mr. Congressman? On the idea of raising additional funds

through some means or another, it strikes some of us that on the Democratic side—if I have this right because I'm not with OMB and this is not my main line of business—but it strikes me and some of us that on the Democratic side there was $20 to $22 billion worth of additional revenues raised in the plan. On the Republican plan that they brought down I think there were about $18 billion. Now they were called different names and they were different. On the Republican side, there are some one-time sales and so forth. On the Democratic side, there were some taxes.

But what strikes one is that one party has proposed $18 billion and another party $22 billion and it seems to me there's a fruitful area for some kind of a compromise that we ought to be able to work something out. That's what I'd hope, but I'm not the technician on that and I haven't been involved in those particular meetings.

Representative SCHEUER. All right. Let me ask you a question on our trade deficit, taking Japan or South Korea as an example. We do have problems of access with both of those countries, but I think it's been estimated that if the problems of access were removed, our $65 billion trade deficit approximately with Japan wouldn't go down more than 10 or 12 or 15 percent maximum.

Secretary BALDRIGE. That's the unfair trading practices part?

Representative SCHEUER. That's correct. Their refusal to give us access to their market for some of our high technology products, for some of our agricultural products and so forth.

But still if those were all removed, we would still have in excess of a $50 billion trade deficit with Japan.

Can you think of anything that could be done in this country to sharpen up our ability to sell abroad, more cost effective labor force, a massive attack on the problem of funcational illiteracy in this country, better corporate decision making? I know that's a private sector matter, but when our steel companies who come begging us for help and protection against foreign imports and they fail to use their cash flow to bring their plant and equipment up to snuff and they engage in adventures buying oil companies and so forth, you really wonder whether corporate decision making can't be sharpened up.

The preoccupation with corporations for this current quarter, how are their profits and losses going to look this quarter and next quarter, instead of the long term, our seeming inability to save the amounts of money that we need to invest in new plant and equipment to be competitive—is there any program that you can think of, of things we ought to be doing to toughen up the American economy, to make our export sector tougher, leaner, more competitive in world commerce?

Secretary BALDRIGE. Mr. Congressman, we have taken, I believe, the most important macroeconomic step in conjunction with other countries when we helped, in effect, push the dollar down, although it would have gone down even without that but that gave an extra push at the right time and the cooperation that we've had since then is well known.

If you look at our $50 or $60 billion deficit with Japan, as you pointed out, if you eliminated unfair trade practices, that would only make about $12 or $15 billion worth of difference. The dollar

decline against the Japanese yen is much more significant than that. That would make a difference of over half of that $50 or $60 billion deficit simply by having Japanese products cost more.

And you're going to see Japanese prices being raised in this country and if American manufacturers hold their line they will be able to increase market share at the expense of the Japanese. By holding their line on costs, the largest Japanese companies had an average profit drop of 40 percent in the last quarter of last year. That shows how much they want to keep the U.S. business. It hurt them that much. We have to be able to do the same thing and, as you point out, that's a private sector economy decision.

But the macroeconomic facts are in place. With the yen-dollar, we are competitive with them and if we can beat the Japanese in areas like we are in some third countries abroad, we can win in the United States of America when they have to ship over here. That, I believe, will be coming out. It believe that American management is getting much better along the lines you talked about because I see, to put it crudely, more and more CEO's fired who never would have been fired in the 1960's and 1970's—you never heard of a Fortune 500 chap getting fired, but now you do. You see a lot of them. I know of 10 or 15 lately. And the new fellow knows why he's put in there and he has to compete and in a lot of cases they're doing it.

So I think it's a combination of macro and micro-economic factors, but I think the big steps have been taken. The one that hasn't been taken is education and if I could add, also policies that would increase saving in the United States. Those are two macroeconomic issues that we ought to face up to.

Representative SCHEUER. Does the administration have any specific policies, programs, legislative initiatives to encourage a greater rate of saving and a greater rate of capital investment in the manufacturing sector where we are in desperate competition?

Secretary BALDRIGE. Well, I don't want to oversimplify, but this isn't oversimplifying. The best thing we could do there is get the budget deficit down so it doesn't sop up so much money.

Now beyond that, there are other things we ought to be doing that would take—it gets outside the purview of my statements here, but we ought to concentrate more on that.

Representative SCHEUER. Thank you very much, Mr. Secretary. Thank you, Mr. Chairman.

Senator SARBANES. Mr. Secretary, I just want to point out two charts in light of the questions and responses to Congressman Scheuer that are in the annual Joint Economic Committee report. One is Federal Government purchases and this ascending line is military. This is military purchases. This line [indicating] is civilian, this one that is pretty well straightened out here. So when you talk about the spending problem, I just want to use that chart to underscore where the problem is.

And related to that—and it's something that you touched on earlier in response to Congressman McMillan—this is nondefense R&D, nondefense research and development as a percent of GNP. These lines are Germany and Japan and this line down here [indicating] is the United States. Actually, you touched on that point in response to a question earlier.

Congressman Solarz.

Representative SOLARZ. Thank you very much, Mr. Chairman.

Mr. Secretary, it's good to see you. I would appreciate it if you could spell out for us what you consider to be the relationship between the budget deficit and the trade deficit and the extent to which the budget deficit has contributed to a deterioration in our trade balance.

Secretary BALDRIGE. The budget deficit has to be financed. The larger it is, obviously, the more money it takes to finance it. The total net savings in the United States is not enough to have a budget deficit plus the net investment that's been going on. So we clearly have to go abroad and entice foreign investors to help finance our budget deficit.

Even though we did have a lower inflation rate than the rest of the world for a long time—and then they began to catch up with it—because our need for financing was as large as it was, to attract those funds we ended up having a real interest rate—that's interest rate after inflation—that was, for most of the time between 1981 and 1986, 1 to 2 percent higher than the other leading industrial countries, the Japanese, the Germans and so forth.

So if we had not had that need to finance, we would not have needed real interest rates to be 1 or 2 percent higher in order to have the marketplace work to attract them in. And with lower interest rates, we would have seen more housing built, we would have seen more investment. The hurdle of rate of return for U.S. industry's investment would have been lower, there would have been more investments made, and that is the correlation as I see it.

Representative SOLARZ. Well, I followed your explanation up to the end but I'm not sure that I understood the conclusion.

How does all of this affect the trade deficit?

Secretary BALDRIGE. The dollar strengthened from 1981 through most of 1985 because the real interest rates were high, because the United States was a safe place to invest, a secure place to invest—all of this compared to the rest of the world—and because we were having a GNP growth that was better than the European Community's and for part of that time better than the Japanese. We had an average GNP growth of almost 4 percent, coupled with safety of investing, coupled with higher rates of interest, all of that means that the dollar strengthened as a result and the strengthening of the dollar, in my opinion, accounts for 60 percent at least of the size of our trade deficit.

Representative SOLARZ. Well, this was the explanation that I had heard in the past.

Secretary BALDRIGE. I've tried to explain 60 percent of it. Now the other 40 percent would take another 5 minutes.

Representative SOLARZ. Well, I think you've articulated well the conventional wisdom on this issue, but if what you say is true, then how does one account for the fact that in spite of continuing very high budget deficits, the value of the dollar has in fact declined 30 to 40 percent over the course of the last year or so?

Secretary BALDRIGE. Well, because of the imperfect economic world we live in, Mr. Congressman, the market vastly overshot the mark on the dollar on the way up. Businessmen and economists, even some respected ones such as are sitting in the room here and

will be on the panel—and I have real humility, as far as knowledge of economics, compared to them—but businessmen or economists both share the same thing. They are confident for too long a period after there's been a change on something that's going to get worse, and they are pessimistic too long after something has changed the other way, and they overshoot the mark all the time. The Federal Reserve does it. The world economic markets did it on the dollar.

Representative SOLARZ. Is it your position that further significant reductions in the budget deficit by reducing the need for financing of the budget deficit would enable us to lower interest rates because they wouldn't have to be so high to attract the foreign capital and that, in turn, would result in a further decline of the dollar which, in turn, would result in a further reduction in the trade deficit?

Secretary BALDRIGE. Exactly, I'm not sure how much a decline in the dollar would be involved. Perhaps that's not a factor. I would leave that to some of the people coming after me, if that would be affected by that.

But some of the practical aspects of that get overlooked sometimes. One is that if we took care of this budget deficit problem—and clearly we're on the way to taking care of it—the Federal Reserve Board would clearly have a great deal more security in being able to ease up on interest rates because they would not see inflation as that large of a problem.

Every time we get after the Japanese and the Germans to stimulate their domestic economy because they can't expect this export-led growth from the United States anymore, and we need something to export to, they turn around and say, "It's your fault; it's your budget deficit." I would like to remove that excuse because I think we'd do better in international harmonization of economic policy.

Representative SOLARZ. You indicated that we have become more and more dependent on foreign capital to finance our budget deficit. Could you let us know how much of the budget deficit is being financed by foreign purchases of "T" bills?

Secretary BALDRIGE. Yes. I had those figures here somewhere. I'll have to come back to you with an answer to that question. I don't find them right here.

Representative SOLARZ. All right. Mr. Secretary, in your testimony and in some of your answers to the questions, you indicated that you felt that the enactment of protectionist legislation could have unwanted and unfortunate consequences for the economy.

Now I want to ask you to comment in particular about the approach embodied in the so-called Gephardt amendment based on the following line of reasoning. I'm sure you would agree that in our efforts to persuade other countries to remove unfair barriers to American exports that we need to rely not just on persuasion but on the implicit threat, as it were, that if they don't take these steps we will either by choice or compulsion end up taking retaliatory measures. That clearly enhanced presumably the negotiating potential of our emissaries when they try to convince the Germans and the Japanese and others to reduce these barriers to trade.

Now keeping that in mind—and I'm sure that so far you probably agree with me—it seems to me that if you look at the Gep-

hardt amendment, which has a pretty big waiver in it that gives the President the right to waive the implementation of it if he believes it will not be in the economic interest of the country—that you can make the argument that the Gephardt amendment does not obligate the President to take any retaliatory measures he doesn't want to take because of the waiver. Whereas, if you had a President who believed, for better or worse, rightly or wrongly, that the kind of retaliation envisioned by the Gephardt amendment would be in the interest of the country, presumably even without the Gephardt amendment, the President could use existing authorities in the law to achieve the same effect.

Consequently, it seems to me the argument could be made that the Gephardt amendment doesn't require a President to do anything he doesn't want to do, while it doesn't prohibit him from doing things that he already has the power to do, but that, in terms of our capacity to negotiate reductions in barriers to American exports abroad, the enactment of legislation like this can enhance the credibility of our diplomats and emissaries and the STR when they say to our foreign economic competitors if they don't agree to the proposals we're making, at least many of them, that the Congress is clearly going to compel this kind of response.

And without legislation like this, the administration may appear to be just crying "wolf" and that implicitly undermines the effectiveness in persuading the other countries to remove some of these barriers.

So how would your respond to that line of reasoning?

Secretary BALDRIGE. Well, Mr. Congressman, your eloquence has made the best of a very bad situation. If I had to take the points and tick them off they would run as follows. If, as you say yourself, there is no more power under this than the President already has under 301 and some of the other statutes, why change it? The President needs all the flexibility he can get. When I say the President, I mean the whole administration.

I've been in a jillion negotiations now. So has Clayton Yeutter. We needed the flexibility. If we're hemmed in by "you have to do this, you have to do this," it effectively blocks you from getting the best results too many times.

You said Presidential discretion, that he wouldn't have to follow through on the bill, he has enough loopholes. However, the political pressure simply because that bill was there would be very, very intense. I'm not worried about the political pressure on this President, but on future Presidents they might not be able to stand up to it in too many cases, and that would be a very practical result of that bill.

And this is what I feel quite sure would happen, we don't think enough in the U.S. Congress and in the administration sometimes, of the fact that we are not without sin ourselves. We think that somehow all that protectionism or all those bad actions are taking place in other countries and if we could just shape them up we'd be home free.

The fact is, those countries could, rightly or wrongly, in a lot of cases come up with mirror image legislation, and they would—I'll guarantee you that they would—their political imperatives at home would force them to. If we're supposed to see imports from

countries that offend us cut by 10 percent a year or whatever the rule is, they would put in the same thing, except they could make the rules that our exports have to be cut 50 percent a year, once the precedent was staked out. I don't mean to be ridiculous about that or exaggerate too much, but I want to get that point across.

What I see around the world is the forces for protectionism are being held at bay in Europe, in Japan, in South America, because of the leadership of the United States in free trade. If we ever lost that leadership, I don't think we would see retaliation in anger, not that kind of retaliation, but I think you would see retaliation around the world by the loss of political will. It would be too tough for other countries' political leaders to stand up aganist protectionism if the U.S. was taking steps like that.

Senator SARBANES. Senator Melcher.

Senator MELCHER. Thank you, Mr. Chairman.

Mr. Secretary, I have a compliment for you and also a revelation for you and lastly a suggestion.

First of all, the compliment. A few years ago I was one of the audience at Cap Center when there was an eastern rodeo and I want to compliment you on your roping ability, both you and your horse. You were very good.

Secretary BALDRIGE. My horse particularly.

Senator MELCHER. Then the revelation, I suspect, Mr. Secretary, you know pretty well about a lot of different budget cuts in the President's budget, but I doubt if you know of this proposed budget cut. In the President's budget is a proposal which requires legislation enacted by Congress to save $340 or $350 million a year by transfering the cost of meat and poultry inspection to the meat packers and processors and the poultry processors.

That proposal would be opposed by, among others—well, the general public as a whole, but consumer groups, the American Meat Institute, all of the poultry processors, and Congress. It would be absolutely a backward step in a public health measure that Congress would not do, will not do, and it was just thrown in to the Department of Agriculture's budget to gain a saving by pencil, knowing full well it would never be accomplished.

Now I doubt whether very many people in the Cabinet are aware of how this budget of the President is put together. What does it mean to us? It means to us, specifically on the Agriculture Committee, since we don't do it, we have to come up with $340 million of other savings to offset that and we'll probably—I don't know for sure, we haven't voted on it yet, but my recommendation for a portion of the savings that we must come with, over a billion dollars, but perhaps $340 million of that, the same amount as in the President's budget on transferring the meat inspection and poultry inspection to the processors, perhaps using some of our surplus corn, barley and wheat for gasohol, do that realizing that it has to be sold at a discount and realizing that gasohol certainly isn't economical but maybe it's worth retaining the bare bones structure we have left in the gasohol plan.

Now as to the suggestion, and I'd like your reaction. Early last month when Mike Mansfield was here with Nakasone, I told Mike that I had a suggestion I'd like him to review and he said, typically, "Well, write it down and I'll look at it." And so I have and he

hasn't responded except to say that he'll have staff look at it. We have a trade bill on the floor that would muscle I guess reciprocity with, among other countries, Japan, in trying to work out our trade imbalance.

I believe that the executive branch could be in the lead with trade policy and perhaps it's fair to say—at least I think it's fair to say that the trade bill that passed the House and the one we're working on in the Senate is a reaction, a frustration, to the very serious trade deficit we had and not enough progress made in reducing that.

Here's the suggestion. We have surplus commodities that developing countries, some of them, need very badly. I'll name a couple. The Philippines and Mexico. If they purchased some of our surplus commodities, the suggestion is this, that Japan open up some of their markets to Mexico and the Philippines, to use just two examples—there would be plenty of examples—realizing that any opening of Japanese markets is going to be measured not in inches but in millimeters, it's going to come very slow, recognizing that as a reality, perhaps there's some merit in thinking that perhaps Japan can open up a small market for whatever from a developing country, we're better off in this suggestion if it could be implemented, in that we have moved part of our products to a developing country that needs it, helping to correct our imbalance, our overall imbalance on trade, and the developing country is benefited by getting rid of some of their products or commodities to Japan.

My thought is that it might be easier for Japan to open markets millimeter by millimeter to a broader array of exporting countries that it would be to rapidly open their markets to use inch by inch. That's the suggestion. I'd like some leadership. I don't know whether this suggestion merits endorsement, but I throw it down and I'd like your off-the-top-of-your-head reaction to this.

Secretary BALDRIGE. I think any way, Senator, to get the Japanese to open their markets is a plus, whether it's to us or anybody else because it helps the whole world, directly or indirectly.

I think what would have to be studied carefully in that idea is what price and how, what terms, we sell the commodities to the Third World countries on, because as you know perhaps better than I do, if you upset those markets we hear about it from the countries who are affected in those particular commodities because they feel it impoverishes them to some extent.

But I think any idea that would open up Japanese markets is worth studying.

Senator MELCHER. Well, I mentioned two countries, one of which cannot produce wheat, the Philippines; and Mexico that produces very little wheat. And while the nutrition in Mexico is adequate in calorie count, just raw calorie count, the nutrition in Mexico is inadequate in a balanced nutrition. That isn't me saying that or some of us saying that. That is Mexico saying that. That's the University of Mexico saying that. So I'm looking for something that is practical where the needs are on both sides, but the overall result is beneficial to reducing our deficit.

Well, perhaps you'll be like Mike. You'll let your staff look at that. I would appreciate it if you would.

Secretary BALDRIGE. Yes, sir.

Senator MELCHER. Thank you.

Senator SARBANES. Thank you very much, Mr. Secretary. We appreciate your testimony. You've been a very helpful witness and it's a pleasure to have had you before us again.

Secretary BALDRIGE. Thank you, Mr. Chairman.

Senator SARBANES. We now have a very distinguished panel, and if they would come forward we would be happy to hear from them. Our panel consists of Fred Bergsten, director of the Institute for International Economics; Donald Hilty, corporate economist, Chrysler Corp.; Robert Hormats, vice president of Goldman Sachs; and Jerry Jasinowski, executive vice president and chief economist of the National Association of Manufacturers.

Is any member of the panel under a particularly serious time constraint?

Mr. HORMATS. A 1 o'clock commitment.

Senator SARBANES. Then, Mr. Hilty, why don't we start with you and we'll just move right across the table. We're very pleased to have you here.

Gentlemen, we have your prepared statements and we will include them in the record. I don't think it's necessary to give them in every detail and if each of you could take 8 to 10 minutes to summarize, we would appreciate it. Then we could go to questions. Mr. Hilty, why don't you start off?

STATEMENT OF DONALD P. HILTY, CORPORATE ECONOMIST, CHRYSLER CORP.

Mr. HILTY. Thank you, Senator Sarbanes.

My prepared statement is in the form of some charts and tables and then brief comments about them, so I will just briefly summarize the main conclusions that I wanted to make.

Senator SARBANES. Those charts were very helpful. Are you going to put some of them up?

Mr. HILTY. Yes.

Senator SARBANES. They are very helpful and I think they make some of the points in a very effective manner.

Mr. HILTY. Although the rest of the panel will be talking more about the macro implications, I want to emphasize that our $260 billion net international debt will continue to increase until our current account changes to a surplus. I think that's a dramatic problem that we have and I also want to mention that I agree with the CED conclusions that were put on the easel earlier.

Paying back this debt, of course, is going to be very difficult and some discussion was mentioned earlier that we really cannot default. We don't want to inflate our way back with cheap dollars. We don't want to sell our land and businesses. Reducing our standard of living will be painful and maybe politically not acceptable. Increasing our competitiveness does seem to be the only viable way to do it.

We have an immediate concern, though, at my company and my industry and I think among most large businesses. Many large corporations, as part of their budgeting and planning processes, have added the risk of an interest rate shock or an exchange rate shock

to their assessment of the business environment due to the current account problems that we have now.

We think that such a shock would be as harmful as the oil shocks in 1973 and 1979. We take this risk very seriously. This is a formal part of our planning process at Chrysler. It even is part of our profit plan for this year 1987. In fact, an interest rate shock maybe has already started. As most of you know, the interest rates have increase 20 percent in the last few months. We are watching this increase in interest rates very carefully.

I agree with Secretary Baldrige that our current account deficit is basically a merchandise trade problem. I, however, disagree with Secretary Baldrige that it will be capped soon and maybe even go into surplus very soon.

Among the 20 largest trading partners, we have deficits with 17. Our deficit with Japan is the largest, with $59 billion in 1986. We do have surpluses with quite a few small countries that are not in the "Who's-Who." The list includes such countries as Falkland Islands, Gibraltor, New Guinea, and Mali. It shows some of the problems that we have.

I'd like to put up one chart. The United States has trade deficits in almost all goods-producing industries. The automotive trade deficit is the largest. In 1986, it was $59 billion. Next is fuels, mainly oil. Together, they account for almost 55 percent of the merchandise trade deficit.

Most analysts, of course, believe the United States is becoming more dependent on foreign oil and, of course, its price is rising. Together, then, oil and autos make up 55 percent of our trade deficit and, in addition to the fact that our oil deficit is probably going to increase, I believe also that the auto trade deficit is likely to increase.

Senator SARBANES. Could you just stop on that chart for a minute? It shows a deterioration in every account between 1982 and 1986 except fuels, is that correct?

Mr. HILTY. That's correct, sir. And that was due to the temporary price reduction we had in fuels when Saudi Arabia was trying to sort out OPEC. So that was more of a price factor than a volume factor.

Senator SARBANES. Including a deterioration in capital goods from plus $30 to minus $10 over that 4-year period?

Mr. HILTY. That's correct. This was due mainly to the strong dollar we had during that period.

I want to emphasize the size of the auto trade deficit and its importance in the overall merchandise trade deficit. Autos accounted for 35 percent of the merchandise trade deficit in 1986. Over half of that was due to the auto portion of the trade deficit with Japan. That's because of the U.S. total trade deficit with Japan, almost 60 percent, was in autos, that is, $35 billion.

And I am here today because U.S. trade depends importantly on the prospects for auto trade.

I want to point out that North America and Western Europe are the major auto markets. Two-thirds of all the cars and trucks sold in the world are sold in North America or Europe. So the potential for exporting outside of those areas are slim.

The Japanese created a large automotive industry as part of their development strategy. Less than half of their production is consumed domestically. Here, I might add that there are two main reasons why I think it's important that we try to convince other countries to increase their economic growth. One, so they will buy more goods from us; but probably more importantly, so that they will be less dependent on their exports to the United States—so that they can consume the goods that they are producing.

More than one-fourth of the auto production from Japan is exported to the United States and available data suggest that the Japanese auto industry in recent years was profitable only in the United States and Canada. This I think dramatizes the importance of our market.

I have another chart that I think is critical to this story. Foreign auto companies made large profits in terms of their local currency while the dollar was especially strong, during the 5-year period, 1980 to 1984. To generate the same amount of yen as before the G–5 meeting in September 1985, Japanese car companies would have to increase the dollar price of cars sold in the United States by 65 percent. They have increased prices only slightly less than 20 percent. The Japanese have increased car prices, therefore, to an exchange rate of about 200 yen per dollar compared to the 145 that we have now.

This means that previous profits may have been so great that accumulated funds are adequate to weather the current discomfort or the U.S. market is so valuable that preserving their export volume is more important than recovering the yen revenue shortfalls. This is the main reason the "J" curve is not working in the auto industry.

U.S. car companies have increased prices only 8 percent during this period since September 1985.

I believe that foreign sourced vehicle sales volume in unit terms will continue to grow. I want to point out that the sources of vehicle imports in the United States are mainly of two types. We have what we call built-up vehicles. Those are vehicles coming in on wheels. And that share is 31 percent of the market now. We think it will stay about 31 percent. We also have transplants. These are the foreign designed autos assembled in the United States. That share is 7 percent of the total car and truck market in the United States. We think it's going to go to 16 percent in 10 years due to the plans that have already been announced.

Many observers thought that the transplants would replace built-up imports. Not much of this is happening. They are continuing to eat into the traditional domestic manufacturers.

Now the domestic manufacturers have adapted to this environment. We at Chrysler are cutting costs. We have plans to cut $2,000 out of the cost of a vehicle. We have identified over $1,000 and are working on that. We also are importing products from abroad to relate to this environment we live in, and we are developing a joint venture with the Japanese.

All of the domestic companies are doing this, but this adaptive strategy is not healthy for the U.S. trade balance. We are adapting and the reason I am here is to say that this adapting will probably not help the trade deficit.

In order to quantify our analysis of the Japanese auto industry, we developed a model and I'd be happy to discuss this with the committee staff if they want to go into this in more detail. It was designed to analyze the sensitive elements that affect the auto trade deficit with Japan.

I listed these, some of the important ones in my prepared statement: the overall market demand, the import share, the transplant share, the foreign content mix, the vehicle mix.

When we combine likely assumptions for each, we come up with the most likely forecast—that does represent the consensus view.

The industry believes that with business as usual—that's with the current policy—the auto trade deficit with Japan is likely to continue growing in the near term. We did recently revise these numbers downward due to the realignment of the currencies, but still the auto trade deficit with Japan is going to continue to increase in dollar terms, in nominal terms, and in unit terms.

The parts portion of exports to the United States from Japan will become a more important portion of this deficit. This parts deficit forecast is based on the assumption that continued public policy pressure will force transplants to increase their U.S. content from the current 30 percent to 50 percent in 5 years. The 30 percent now means that three transplants have as much foreign content as two built-up units. The 50 percent U.S. content that we think transplants are going to in 5 years with continuing policy pressure, means there still willl be as much foreign content in two transplant vehicles built in the United States as one built-up import.

If this pressure does not continue, the auto trade deficit will rise even faster.

Our analysis suggests that we could cap the auto trade deficit with Japan in 1988 at the 1986 level—and I mean just cap it, not turn it into a surplus—by several ways. If the dollar weakened to 120 yen to the dollar, we could cap the trade deficit with Japan in autos. If the Japanese were convinced to increase prices 12 percent faster than the rate of inflation in 1988, this would cap the auto trade deficit.

If there was a limit to the number of cars and trucks they could import, for example, from the 2.3 million in 1986 to 1.8 million in 1988; this would cap it. Lowering the market, for example, through a recession, down to a market of 8.7 would do it. Another way would be to increase exports, but there would have to be such a dramatic increase in exports.

Last year, the U.S. industry exported 50,000 units abroad. Exports would have to increase to half a million, in order to cap the trade deficit with Japan.

One aside here. Most auto firms in the United States do intend to increase their exports, but we find that if we want to export a U.S.-designed car or truck, the financial incentives are much greater for us to export these vehicles from Canada or Mexico due to their export incentives.

Representative SCHEUER. Due to what?

Mr. HILTY. Due to the export incentives that they have. If we exported our U.S.-designed car from Canada, they would forgive about 9 percent excise tax. If we exported it from Mexico, the

Common Market would give them preference, because they are a developing country.

It is the problem of different tax systems, the value-added system in Europe versus what we have in the United States; that is the main culprit. So it is a warning here that even though we would like to export from the United States, there is a financial incentive to do it from our neighbors.

Representative SCHEUER. Excuse me. I didn't get that. You would like to export——

Mr. HILTY. Yes. We would like to increase our exports, but there is a financial incentive to export from our neighbors rather than from the United States, from our neighbors, Canada and Mexico.

Representative SCHEUER. Why is that, if I may ask?

Mr. HILTY. It is mainly because U.S. exports to VAT countries have a double tax penalty. In order to reduce this problem, Canadians have an excise tax that they forgive on exports. The Common Market gives a tariff incentive to goods coming from Mexico that they don't give to goods coming from the United States.

Also, the recent tax revision has made it more financially viable to build a plant in Canada or in Mexico than in the United States; companies recover their investment faster, if they build a plant in Canada or in Mexico.

So to conclude, policy changes are needed to cap the auto trade deficit. Our detailed analysis of the U.S. trade deficit with Japan and application of this work to vehicle imports from other countries suggests that there are some alternatives. Reducing the Federal budget deficit, we think, is No. 1. We feel this would lower interest rates and stimulate domestic demand. It would have healthy aspects in quite a few areas of our business. A stronger foreign currency or a weaker dollar would also work toward capping the autor deficit.

Barring these macro changes in policy, there would probably be sector-specific actions needed, in order to cap the auto trade deficit. It would require a bilateral agreement of some sort with Japan and the other major importers. A recession would do, but that doesn't seem to be a viable alternative. Persuading larger foreign price increases would do it. This would require something like a business transfer tax. Another option would be to restrict foreign content. Of course, in the longer term, increasing domestic competitiveness is critical. We think management, labor, and government all have rules.

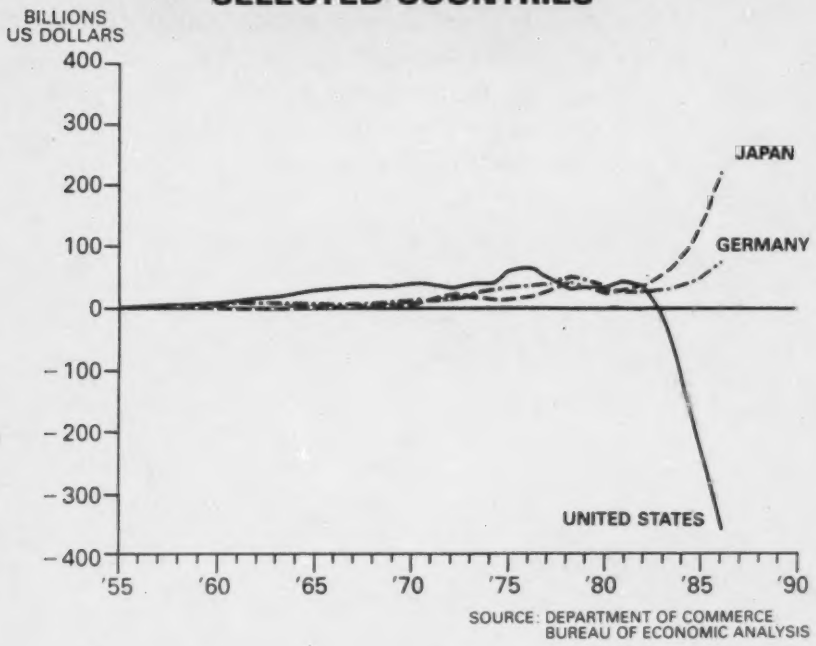
So to conclude, the large and growing trade deficit is a serious problem for the United States. We think significant improvements in this deficit will be difficult, due to prospects for the auto trade. A single policy action is unlikely to change this outlook substantially. Probably, a mixture of several actions are needed.

That concludes my informal remarks.

[The prepared statement of Mr. Hilty follows:]

PREPARED STATEMENT OF DONALD P. HILTY

CUMULATIVE CURRENT ACCOUNT BALANCES SELECTED COUNTRIES



- o Between the early 1950's and 1981, the U.S. was accumulating IOU's from other countries.
- o All that changed in 1982. In just four years, our cumulative current account deficit has reached about $350 billion.
  - We have repaid about $90 billion by selling assets owned abroad and in the U.S.
- o Our net international debt will continue to increase until our current account changes to a surplus.
  - Even "best case" estimates are that this debt will reach $800 billion to $1 trillion before it can be reduced.
    - Service fees, alone, would amount to around $70 billion per year.

HOW DO WE PAY BACK OUR FOREIGN DEBT?

- DEFAULT ON TREASURY DEBT
- INFLATE AND PAY BACK WITH CHEAP DOLLARS
- SELL OUR LAND AND BUSINESSES
- ACHIEVE TRADE SURPLUS
  - —REDUCE U.S. STANDARD OF LIVING
  - —INCREASE COMPETITIVENESS

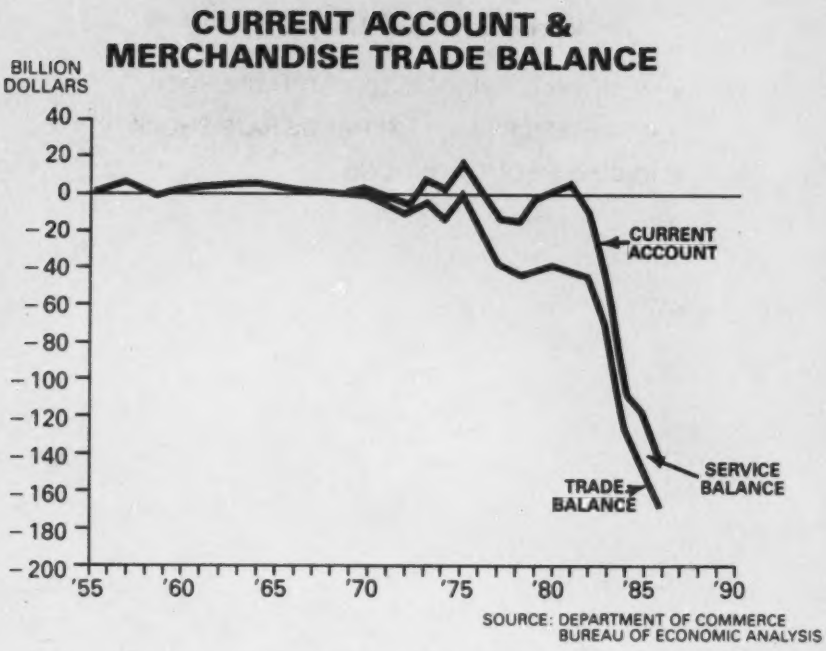
o Not many options exist for paying back this foreign debt; all are painful.

- Defaulting is not viable.
- History tells us inflating is exceedingly painful.
- A sovereign nation places a limit on the amount of land and enterprises it willingly sells.
- Persuading foreigners to buy more of our exports and moderating our imports are not easy accomplishments.
  - . Reducing our standard of living has political risks.
  - . Increasing our competitiveness without reducing wage levels to unacceptably low levels has to be more than a slogan - it seems the only viable alternative.

WHY THE CONCERN?

- INCREASES RISK OF INTEREST RATE SHOCK
- INCREASES RISK OF EXCHANGE RATE SHOCK
- REDUCES POLICY OPTIONS

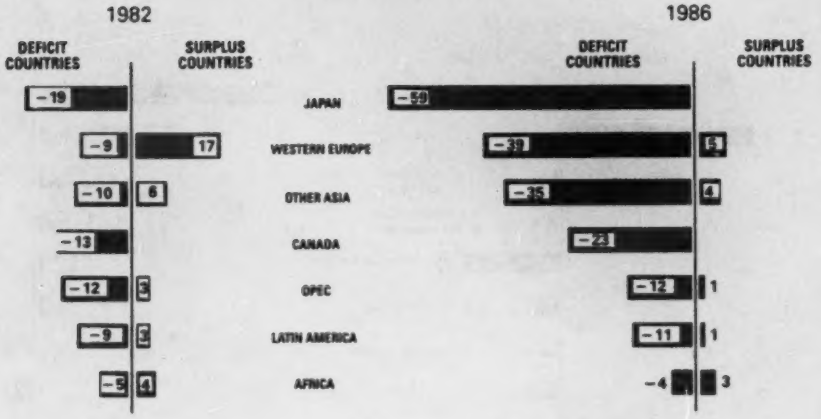
- Continuing with "Business As Usual" increases risks of an interest rate shock or an exchange rate shock.
- Our international influence is reduced.
- Domestic policy options are narrowed.



- o Our current account deficit is basically a merchandise trade problem.
  - Service exports will not likely play any significant role in closing the current account deficit.
    - Investment income, the largest surplus item, will soon turn negative.

U.S. MERCHANDISE TRADE BALANCE BY MAJOR AREA

IN BILLION DOLLARS

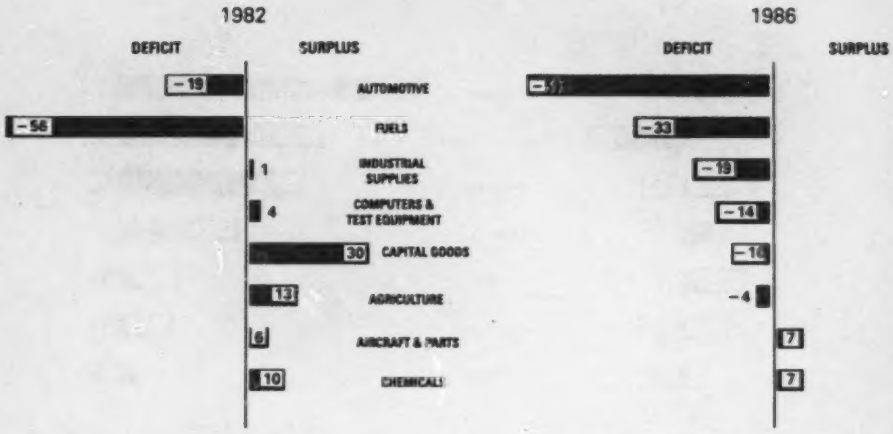


SOURCE: DEPARTMENT OF COMMERCE
BUREAU OF CENSUS, FT990

- o Among our 20 largest trading partners, we have deficits with 17.
  - Our deficit with Japan is the largest.
- o Our largest surplus is $3 billion with the Netherlands.
  - We do have surpluses with quite a few small countries, such as Falkland Islands, Gibraltar, Bahrain, Papua New Guinea, and Mali!

U.S. MERCHANDISE TRADE BALANCE BY MAJOR INDUSTRY

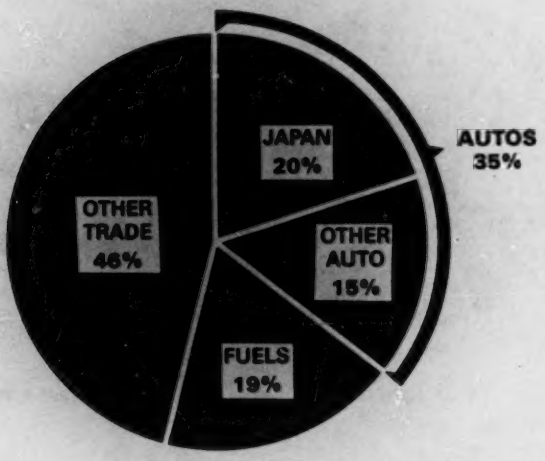
IN BILLION DOLLARS



SOURCE: DEPARTMENT OF COMMERCE/ BUREAU OF CENSUS, FT990

- o By 1986, the U.S. had trade deficits in almost all goods producing industries.
  - The automotive trade deficit was the largest.
- o Next is fuels, mainly oil.
  - Together, they account for 54% of the merchandise trade deficit.
  - Most oil analysts believe the U.S. is becoming more dependent on foreign oil and the price of it is rising.
- o The only major industries in surplus are aircraft and chemicals; even agriculture is in deficit.
- o Turning our merchandise trade balance from deficit to surplus will be difficult.

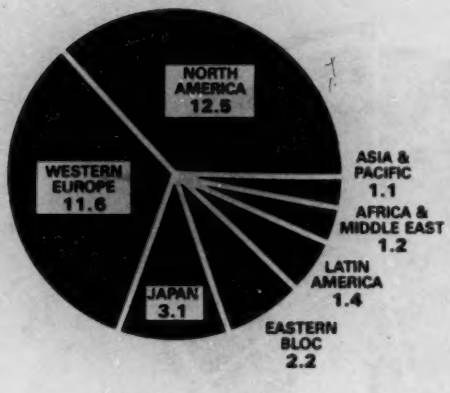
U.S. MERCHANDISE TRADE DEFICIT, 1986



SOURCE: DEPARTMENT OF COMMERCE
BUREAU OF CENSUS, FT 990

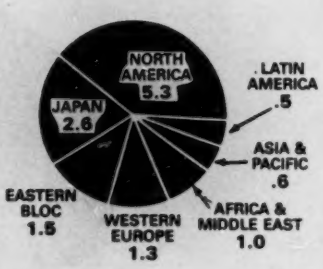
- Autos accounted for 35% of the merchandise trade deficit.
  - Over half of that was due to the auto portion of the trade deficit with Japan.
- The outlook for U.S. trade depends importantly on prospects for auto trade.

WORLD AUTO MARKET, 1986
(MIL UNITS)



PASSENGER CARS

33.1



COMMERCIAL VEHICLES

12.8

SOURCE: VARIOUS OFFICIAL SOURCES

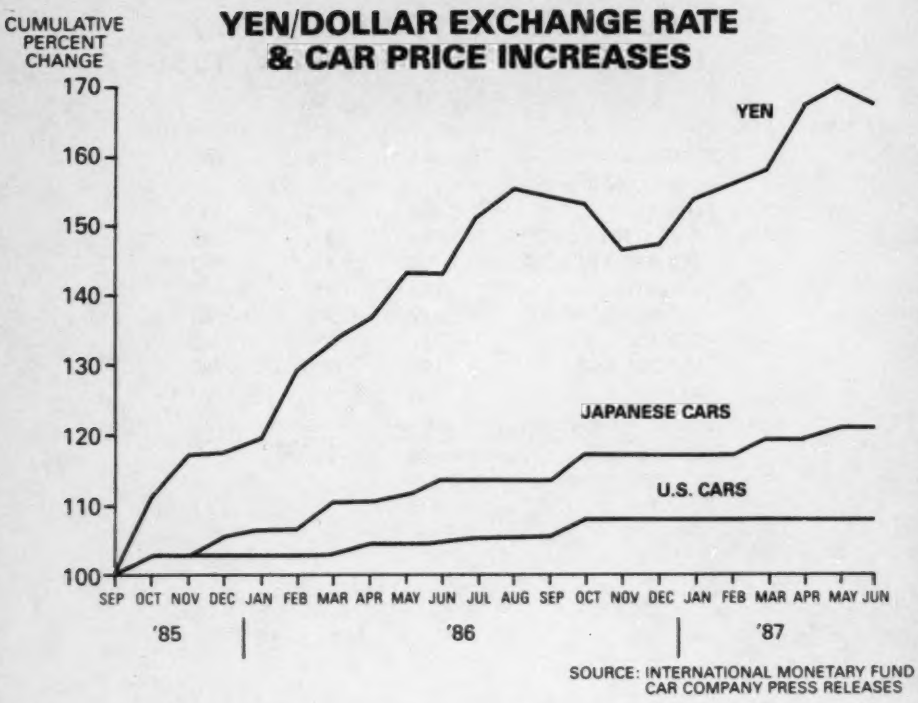
- o North America and Western Europe are the major auto markets.
  - Japan is a distant third.
- o These patterns are important when contemplating export opportunities.

JAPANESE AUTO PRODUCTION EXPORTS & PROFITABILITY, 1986

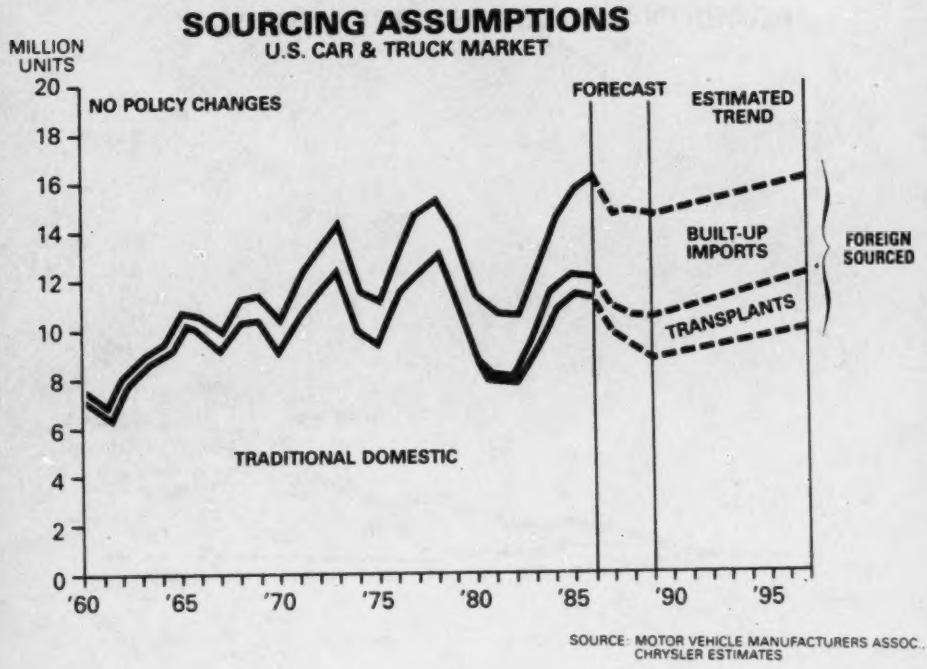
	CAR & TRUCK PRODUCTION		
	THOUS. UNITS	PERCENT	PROFITABILITY
DOMESTIC MARKET	5,656	46%	NO
EXPORT MARKETS			
U.S.	3,434	28%	YES
WESTERN EUROPE	1,544	13%	NO
SOUTHEAST ASIA	456	4%	NO
CANADA	285	2%	YES
LATIN AMERICA	277	2%	NO
OCEANIA	261	2%	NO
MIDDLE EAST	199	2%	NO
AFRICA	126	1%	NO

SOURCE: JAPANESE AUTOMOBILE MANUFACTURERS ASSOCIATION, ANNUAL REPORTS OF JAPANESE AUTO COMPANIES, REPORTS BY AUTO INDUSTRY ANALYSTS

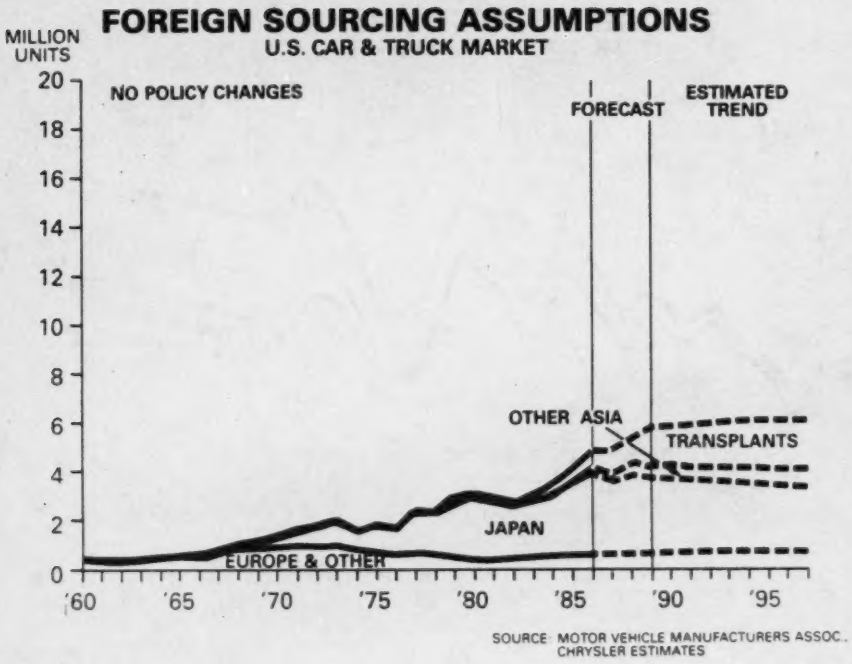
- The Japanese created a large automotive industry as part of their development strategy.
  - Less than half of their auto production is consumed domestically.
    - This is a dramatic example of dependence on export markets.
  - More than one-fourth of their auto production is exported to the U.S.
  - Available data suggest the Japanese auto industry in recent years was profitable only in the U.S. and Canada.



- o To generate the same amount of yen as before the G-5 meeting in September 1985, Japanese car companies would have to increase the dollar price of cars sold in the U.S. by about 65%.
  - They have increased prices slightly less than 20%.
- o Japanese have increased car prices to restore yen revenue to an exchange rate of only 200 yen per dollar.
  - Previous profits may have been so great that accumulated funds are adequate to weather the current discomfort.
  - Or, the U.S. market is so valuable that preserving export volume is more important than recovering yen revenue shortfalls.
  - These are some important reasons the "J curve" has not worked as expected.
- o U.S. auto companies have increased car prices only 8% during this period - since September, 1985.



- o With no policy changes, this seems a reasonable estimate of the U.S. automotive market and likely sourcing pattern.
  - This growth estimate was revised downward by most industry analysts due to the recent yen/dollar realignment.
- o Foreign sourced vehicle sales volume will likely continue to grow.
  - These sources include imports of built-up vehicles (on wheels) and transplants (foreign autos assembled in the U.S.).
  - Many observers assumed transplants would replace built-up imports. Not much of this has happened. They are taking share from traditional domestic plants.



- o The structure of foreign automotive sourcing is changing.
- o European manufacturers have successfully exported to the U.S. about 1/2 million large and luxury cars per year.
- o Japanese firms dramatically captured an impressive share of the small car and truck markets.
  - They now are attempting to move upscale.
- o Imports from other Asian nations are a new development.
- o Public policy pressures have sparked plans to construct transplant facilities here.
  - An important aspect of future foreign sourcing will be the prospective domestic content of these transplants.

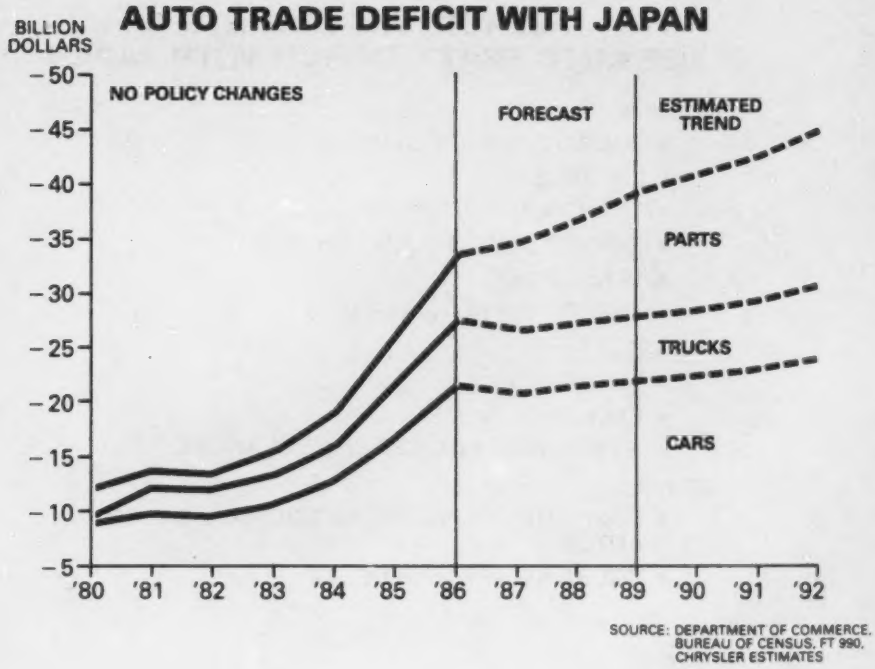
SENSITIVE ELEMENTS OF AUTO TRADE DEFICIT WITH JAPAN

VOLUME
- OVERALL MARKET DEMAND
- IMPORT SHARE
- TRANSPLANT SHARE
- TRANSPLANT FOREIGN CONTENT
- VEHICLE MIX
- OFFSETTING AUTO EXPORTS

FINANCIAL
- AUTO PRICES
- EXCHANGE RATES
  —EXCHANGE INDUCED PRICE CHANGES

OTHER
- COMPETITIVENESS OF TRADITIONAL DOMESTIC AUTOS
- SOURCING ARRANGEMENTS

o In an effort to quantify our analysis, we developed a model of U.S. auto trade with Japan.
  - It was designed to estimate the role of sensitive elements of auto trade.
  - What is the most likely outlook for the U.S. auto trade deficit with Japan?
  - What has to happen to improve the trade balance with Japan?



- o With "Business As Usual", the auto trade deficit with Japan is likely to continue growing in the near term.
- o The recent yen/dollar currency realignment has slowed the expected rate of increase.
- o Parts exports from Japan to the U.S. will become a more important portion of the deficit.
  - The growing parts deficit, shown above, is based on the assumption that continued public policy pressure will force transplants to increase U.S. content from the current 30% rate to 50% in five years.
    - If this pressure does not continue, of course, the auto trade deficit will rise faster.
  - Replacement parts trade is also increasing to service the growing numbers of Japanese-sourced vehicles on U.S. roads.

INDIVIDUAL ACTIONS THAT WOULD CAP AUTO TRADE DEFICIT WITH JAPAN AT 1986 LEVEL

	ACTUAL	ESTIMATES	
	1986	1988	1992
• WEAKER DOLLAR (Y/$)	168	120	100
• ADDITIONAL PRICE INCREASES (PERCENT)	—	12	25
• REDUCED CAR IMPORTS (MIL UNITS)	2.3	1.8	1.1
• LOWER CAR MARKET (MIL UNITS)	11.4	8.7	5.2
• INCREASED U.S. VEHICLE EXPORTS WORLDWIDE (MIL UNITS)	.05	.5	1.2

- o Dramatic action would be needed to put a cap on the auto trade deficit with Japan at the 1986 level.
  - The table above shows specific performance in each category to accomplish this goal.

WHAT WOULD CAP AUTO TRADE DEFICIT?

- REDUCE FEDERAL BUDGET DEFICIT
- STRONGER FOREIGN CURRENCIES/WEAKER DOLLAR
- BILATERAL AGREEMENT
- RECESSION
- PERSUADE LARGER FOREIGN PRICE INCREASES
  —EXAMPLE: BUSINESS TRANSFER TAX
- RESTRICT FOREIGN CONTENT
- INCREASE DOMESTIC COMPETITIVENESS
  —MANAGEMENT, LABOR, GOVERNMENT HAVE ROLES

- o Policy changes are needed to cap the auto trade deficit as suggested by
  - Our detailed analysis of the U.S. trade deficit with Japan.
  - The application of this work to vehicle imports from other countries.

CONCLUSION

- The large and growing trade deficit is a serious problem for the U.S.
- Significant improvement of this deficit will be difficult due to prospects for auto trade.
- A single policy action is unlikely to change this outlook substantially; many actions are needed.

Senator SARBANES. Thank you very much, sir. Very helpful testimony.

Fred Bergsten, please proceed.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, thank you very much.

Your topic for these hearings is the economic outlook at mid-1987. And I think that outlook is quite fragile, because of a series of international economic perils that I stress and lay out in my prepared statement.

Senator SARBANES. You could almost say we are skating on thin ice.

Mr. BERGSTEN. You could say that.

And all those perils do derive from the huge imbalances in the world economy, our international economic position, any or all of which I fear could drive our economy into recession sometime within the next 6 to 18 months.

Although it is not today's topic, I think a key issue for this committee is to note that when we get into that next recession in the United States, as we inevitably will, it is going to be very hard to get out of it, because neither the usual fiscal or monetary policy tools will be available, and that means our next recession in this country might be unusually prolonged because we don't have the normal tools to extricate ourselves from it.

Now before I talk about my perils, briefly, I would first convey some good news. They have, of course, been efforts underway for a couple of years to reduce the big U.S. trade deficit.

First, Mr. Chairman, just to elaborate on the point you made in your opening statement, my qualification is that it is going to take a swing of about $200 billion in our annual trade position to achieve your purpose of getting back to a balanced or small surplus in the current account position. We have been running a current account deficit, an annual rate of $150 billion. The servicing costs on the big debt that is being built up is not as bad as people think, but it will still be substantial, $20 billion to $30 billion by the end of the decade, and we are clearly going to have a further increase in our oil import bill, if only because domestic production has declined sharply, and of course, it would be worse if prices rose significantly, as they well may, over the next few years.

So when you put it together, I think, in rough terms, our objective to achieve your target of current account surplus and start reducing the foreign debt has to be a turnaround of something like $200 billion in our annual international position.

So when we compare the current situation, the gains from the decline in the dollar and other policy changes that have been taken or promised. I think we should compare them with the objective of an improvement of something like $200 billion by the time we level off. And that is the way I like to size the problem.

Now the good news is that there has been some movement toward achieving that improvement. And I would stress, Mr. Chairman, that in assessing the outlook for the trade deficit, we really should focus on the performance in volume or real terms rather

than nominal or money terms, because it is primarily the volume of exports and imports that affect jobs and production. The volume figures respond to currency changes much more rapidly than the value numbers and thus offer a far superior picture of trends and their outlook. We, of course, now focus entirely on real GNP not nominal GNP, and I will bet even you members of this committee don't know what the nominal GNP is or what its growth rate is, because you focus, quite rightly, on real GNP.

The problem is that in trade we haven't caught up.

Senator SARBANES. We appreciate the assumption that we know the real GNP figure. [Laughter.]

Mr. BERGSTEN. I do assume that, Mr. Chairman.

So on the GNP side, we have moved to focus on volume rather than nominal, but on the trade side, we continue to focus on nominal, not volume. And so I make a specific legislative proposal to you today, that you get the Senate to amend the trade bill that is now on the floor to require the Commerce Department each month, when it publishes the nominal trade data, to also publish the trade data in volume terms, because that would give a much better picture of where things are going and certainly would give a much better picture of the impact on jobs and profits and production, which is what the members, I think, care about in approaching the trade legislation.

I think that would be a very healthy change. It would improve our understanding and analysis of what is going on, and even though, again, that is a little apart from today's testimony, I would recommend it to you because you have an opportunity to do that with the trade bill.

Now in volume terms, and Secretary Baldrige said it, so I will go over it quickly, U.S. trade performance quickly has turned around. Over the last 6 months, exports have been expanding at an annual rate of about 15 percent and imports are flat.

Interestingly, that it is the exact reverse of what has happened in Japan. In 1986, the volume of Japanese exports was flat or even down a little bit and the volume of Japanese imports was up almost 15 percent. Again, the volume effect was clouded and even masked by the currency changes themselves and the price effects, but these volume changes inevitably do lead to changes in the nominal numbers, and that will begin to come later this year.

The United States has, therefore, already begun to experience export lead growth. In fact, the improvement in our trade surplus was the entire explanation for our fourth quarter GNP growth. It was the only sustainable element in first quarter GNP gowth. It should boost real GNP by about a full percentage point this year and next.

And so I would submit that there is the beginning of progress; however, having said that, I have to say, it is only the beginning, because if we set the goal at a swing of something like $200 billion, and even take my relatively optimistic forecast of what has happened so far now back to nominal terms, we are only going to get the trade deficit down to $100 billion, plus or minus a few billion. And that means we have only achieved something like 30 to 40 percent of the needed swing to achieve the purpose that you set out, quite rightly, in your opening statement.

In other words, the dollar, where it is now, plus the other policy changes that have been taken, are at best going to get us less than halfway toward achieving the needed adjustment in our trade position.

So when the officials of the major countries get up, as they did in Paris in February or as they did at the Venice Summit last month, and assert that the current exchange rate relationship reflects underlying equilibrium, they are just not credible, unless they believe that underlying equilibrium means continuing U.S. deficits of $100 billion or so a year, which I think is not sustainable, either in internal or external terms, it is completely impossible, and that is why you are, therefore, going to have continuing further pressure on the exchange rate of the dollar.

Now there are only four ways to achieve the remainder of this adjustment that we need. One is to do it wholly through a further fall of the dollar exchange rate. That would probably require the dollar to go down another 30 percent.

A second way to do it is a sharp U.S. recession, but we obviously don't want that.

A third way, and the healthy one, is to cut our budget deficit significantly, because that will reduce the demand for both overseas funds and overseas product.

And the fourth way, which would be the best for us, would be if the foreigners would pick up their growth rate sharply, expanding the market for our exports around the world.

None of those four steps could do it by themselves in any healthy way, but those are the four options.

Now given that as background, I see four potential perils arising out of this situation, all of which, I think, raise extremely serious risks for the U.S. economy.

The first peril would be a free fall of the exchange rate of the dollar. If you take the analysis that I have outlined, that the adjustment so far only gets us 30 to 40 perecent of the way down the road, and if you take the pessimistic but not wholly unrealistic view that nothing is being done on our budget deficit for the future or foreign growth pickup for the future, then it is not unreasonable to conclude that this remaining adjustment will have to be achieved wholly through a further sharp decline of the exchange rate of the dollar. It might be 30 percent or so.

There is a lot of very respectable and respected economists who have that view. Marty Feldstein, Rudy Dornbush. A lot of prominent U.S. economists have been publishing the view the dollar must fall under the 30 percent. Well, that would, over time, restore equilibrium in our external accounts, but in the meanwhile, it could have some very adverse effects on the economy. It would clearly push our inflation rate up significantly, because of the higher price of imports and the higher prices that would, therefore, be permitted for domestic products. And most importantly, it would probably push our interest rates well back into double digits.

The reason I suggest this is a very dangerous outcome, is because I look at what happended over the last 6 months, and suggest that over the last 6 months, we may have actually been in the first stage of a free fall of the dollar. Note that in the first half of this year, the dollar fell by 10 to 15 percent, while U.S. interest rates

rose by 2 percentage points or more. Now normally, when your interest rates rise, capital is attracted to your currency, and it strengthens. But in this period, the dollar actually continued to fall sharply, while our interest rates were rising sharply and that is, in some sense, the definition of a free fall of the dollar. It is not so much how far or how fast it falls, it is that it falls in the context of adverse domestic economic developments. In this case, higher interest rates.

To me, the most important economic statistic of the first half of this year was the following:

Intervention in the dollar market by foreign central banks was higher than the total of our external trade deficit.

In other words, foreign central banks apparently financed all of our external deficit in the fist half of this year. What that means is that private foreign capital was not coming into the dollar at all. Indeed, it looks like, from the statistics, there was a small outflow of private money from the dollar. The central banks, therefore, had to pick up the total with official intervention and that, by definition, means foreigners are no longer putting money into the dollar on an investment basis that could sustain our external deficit.

If that were to continue, and the central banks themselves, were to get tired of doing it, which they shortly will, for a variety of reasons, then we could have a very sharp further fall of the dollar, combined with a sharp rise of interest rates, meaning high inflation and undoubtedly pushing our economy into recession.

That is the free fall scenario. I think it is a serious risk. I think if alternative steps are not taken to correct our external deficit in a more constructive way, that that is a very significant possibility with very potentially adverse effects on the economy as a whole.

My second peril, which I go over very briefly, is an outbreak of trade protection. If, by whatever device, we don't get the current account position back somewhere close to equilibrium and seem to be on a path to do so, then I think the protectionist pressures, which you are now dealing with on the floor of the Senate, clearly will carry the day to a substantial extent.

If you look at the history of U.S. trade policy, you find out the exchange rate of the dollar and the trade balance are the best leading indicators of trade policy, even though trade policy changes, as you were saying, Mr. Congressman, aren't going to have too much effect on the trade deficit itself. That generates the pressure, and I think, unless we get a constructive improvement of the trade deficit, protectionist pressure will increase enormously. That, in turn, would not only lead to mirror legislation, retaliation of the type Secretary Baldrige talked out, I think it would have a pervasive psychological effect on the world economy, because a big outbreak of protection really would signal a breakdown of international economic cooperation and a return to the kind of Smoot-Hawley era of the 1930's. I think that would have a chilling effect on private investment, both in this country and around the world and could sharply reduce the outlook for world economic, and that too could push us toward recession.

My third peril, very quickly, is the point that Congressman Solarz was raising earlier. If our trade deficit comes down, for example, because the dollar declines further, that will mean that for-

eign capital inflow to the United States, even if confidence is maintained, also decline, because the capital inflow equals the trade deficit. So if the capital inflow declines while our budget deficit is still at anything like current levels, then we will simply have a shortage of available funds to finance the budget deficit combined with any reasonable level of private investment. And since the budget deficit can't be reduced overnight, private investment would be squeezed out.

So my third peril is that if you don't get the budget deficit down, we may, in fact, see a reduced trade deficit, but it would happen in an unhealthy way that would push up interest rates, squeeze out the private sector and also produce a likely recession or sharp turndown in the economy.

Now that means that the crucial policy imperative is to get the deficit down. Doing so would avoid the need to do it all through a lower dollar with the risks that that creates. It would reduce or obviate the risk of a crowding out of the type I just mentioned, and by bringing the trade deficit down, would help cope with the protectionist problem.

And so I really think the major policy punch line is the old one—reduce the budget deficit by something like $30 billion to $40 billion annually over the next 3 or 4 years.

But that, then, raises my final peril, because, if the United States brings its budget deficit down and reduces it domestic damage growth sharply, which we must do to get our trade deficit under control, then the remaining question is where does world economic growth get its impetus. And that requires the other major countries, the Japanese, the Western Europeans, particularly Germany, to sharply expand the domestic demand in their economies. They are simply not doing it by enough. The Japanese have begun, but it is only a beginning. They should aim to increase domestic demand growth in their economies by 2 or 3 percent a year for the next 2 or 3 years. If they don't do that, and we do what is right from our side, the world economy will again slip into recession.

And that is my fourth peril.

So there are a number of very difficult and risky situations out there. They all derive from the legacy of these big international imblances. From our side, it is imperative to deal with the issue through getting the budget deficit down or else the risks could overwhelm the economy and the next 18 months could be very nasty.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Bergsten follows:]

PREPARED STATEMENT OF C. FRED BERGSTEN

The Four Perils Facing the US Economy

Four major perils threaten the US economy over the next six to eighteen months. All derive from the huge imbalances in our international economic position. Any or all of these perils could drive our own economy, and the world economy as a whole, into recession. That next recession may in turn be quite prolonged, at least for the United States, because none of the usual policy instruments will be available to counter it: fiscal policy will be hamstrung because the budget is already in such huge deficit, and monetary policy may also be immobilized if the dollar is still under substantial downward pressure in the exchange markets.

The four perils are:

1. A "free fall" of the dollar, as a result of inadequate flows of new foreign investment into the United States, pushing our inflation rate temporarily into high single digits and our interest rates well into double digits.

2. A major outbreak of protectionism, perhaps via the passage of destructive trade legislation by the Congress, disrupting the international trading system and undermining worldwide confidence in economic cooperation among the major countries.

3. A continued failure of the Administration and Congress to agree on a credible program to bring the US budget deficit under control, coupled with a substantial decline in the trade deficit and hence inflows of foreign funds, pushing up interest rates and "crowding out" the private sector.

4. A failure of Japan and Europe (led by Germany) to achieve adequate expansion of domestic demand, dragging down the world economy in the absence of the American locomotive of the past five years.

Some would add a fifth peril: renewed eruption of the Third World debt crisis. I do not believe, however, that Third World debt on its own will trigger a world economic turndown (or financial crunch).[1] But if the other perils cited were to produce a world recession, particularly one accompanied by higher interest rates or increased trade protection, Third World debt

1. William R. Cline, Mobilizing Bank Lending to Debtor Countries, Washington: Institute for International Economics, June 1987.

would clearly re-enter the crisis zone and greatly intensify the adverse effects already triggered by such events themselves.

The Underlying Situation: The Good News

Each of these four perils derives from the legacy of the huge international imbalances which developed during the first half of the 1980s. The United States ran a current account deficit of $141 billion in 1986 and that deficit was running at an annual rate of almost $150 billion in the first quarter of this year. Japan had a current account surplus of about $100 billion in the year ending March 1987. Germany's surplus approached $40 billion during this same period.

Efforts to correct these imbalances have been underway for about two years. The dollar, whose overvaluation in trade terms was the source of about three quarters of the rise of the US trade deficit from 1981 to 1986, has declined by 30-40 percent (depending on which index is used). As a result, adjustment of our deficit is clearly underway.

In assessing the outlook for the trade deficit, we should focus on its performance in volume, or real, terms. It is primarily the volume of exports and imports that affects jobs and production. The volume figures respond to currency changes much more rapidly than the value numbers, and thus offer a far superior picture of trends and the outlook. We now quite properly focus on real rather than nominal GNP. Indeed, I would recommend that the Senate amend the pending trade legislation to

require the Department of Commerce to publish volume numbers for exports and imports along with the value data in its monthly statistical releases; such figures now emerge only as part of the GNP data, on a quarterly basis and with such long lags that they receive scant attention by the press and public.

In volume terms, US trade performance has clearly turned up. Exports have been expanding at an annual rate of about 15 percent over the past six months. Imports are flat. Not surprisingly, Japan's volume performance in 1986 was almost exactly the opposite--exports flat, imports up almost 15 percent.

Net exports of goods and services, as defined in volume terms in the GNP accounts, improved at an annual rate of $30 billion from the third quarter of 1986 through the first quarter of 1987. The trade improvement accounted for the total (very modest) gain in GNP in the fourth quarter, and was the only sustainable portion of growth in the first quarter (with the rest due to an inherently temporary buildup of inventories). It should boost real GNP by close to a full percentage point in 1987, and perhaps again in 1988. Hence the United States has begun to experience export-led growth, a pattern which is almost certain to prevail for the next several years (for reasons to be described shortly).

The nominal trade numbers, which most observers follow, should also begin to improve in the near future. (They lag because the higher prices for imports which follow dollar depreciation offset the volume gains for a while.) I expect the

nominal trade deficit to be falling by annual rates of about $30 billion by later this year, and by another $30-40 billion in 1988.

The Underlying Situation: The Bad News

Having reported some modestly good news, I must unfortunately emphasize the remaining bad news. Even if I am correct that the trade balance will decline substantially over the next eighteen months, and I am admittedly near the optimistic end of the spectrum of forecasters on this issue, our nominal current account deficit will not fall much below $100 billion on the basis of current exchange rates and economic policies in the major countries.

Hence the officials of the major countries are simply not credible when they assert, as the Finance Ministers did at the Louvre in February and the summiteers did in Venice last month, that current exchange rates are roughly in line with underlying equilibrium. This would be true only if one believed that US deficits of around $100 billion, and Japanese surpluses of around $75 billion, were sustainable indefinitely.

But these imbalances are clearly not sustainable, for two reasons. The external unsustainability is that foreigners will simply not finance US deficits of this magnitude indefinitely--and may have already stopped, as described below. The internal unsustainability is that protectionism would then clearly break out in a massive way because our domestic politics will not

accept the adverse effects on employment and US industrial structure of such huge deficits. Substantial further adjustment is required.

There are four ways to achieve this further adjustment:

-- a further fall in the dollar, of as much as 20-30 percent if relied upon to achieve all of the remaining correction, which could conceivably occur in an orderly way but would be more likely to drive up inflation and interest rates as noted above;

-- a sharp US recession, which would cut imports along with everything else, but would obviously levy excessive costs on the nation and would hardly produce sustainable adjustment in any event;

-- steady and sizable reductions in our budget deficit, which would check our domestic overspending and reliance on capital inflows in an orderly and constructive way;

-- a sharp pickup in economic growth abroad, producing more buoyant markets for our exports and lessening the export drives of our major competitors.

-- (I do not cite trade protectionism, which some might list as a fifth option, because I believe it would produce so much foreign retaliation and world economic disruption

that our trade balance would experience little if any benefit as a result.)

The key issue for the next six to eighteen months is which combination of these options will prevail. As noted at the outset, I believe that the answer to this question will go far to determine the course of our overall economy during this period.

The Outlook

The first peril, a "free fall" for the dollar, could occur if the markets conclude that the international adjustment must go much farther and that none of the other options are likely to occur.

Indeed, there is considerable evidence that we have already entered at least the opening phase of such a phenomenon. During the first few months of this year, the dollar declined by about 10 percent while US interest rates rose sharply--by as much as 2 full percentage points toward the longer end of the monetary spectrum, opening up a positive spread of as much as 5 percentage points by comparison with yen assets. This juxtaposition of a falling exchange rate and rising interest rates is in fact the best short definition of a "free fall" of a currency.

The reason this occurred is that, on balance, private investors stopped putting money into the dollar. For the first five months of this year, intervention by foreign central banks is reported to have totaled about $70 billion. The US current

account deficit during this period was no more than $60 billion. Hence all financing of our external deficit so far this year appears to have been provided by foreign monetary authorities, indicating that there may in fact have been a net outflow of private capital from the dollar.

This "investment strike" indicates why the sharp rise in interest rates co-existed with a falling dollar (rather than a sharply rising dollar, as in the early 1980s). If the dollar were viewed as likely to fall further, by anything like 20-30 percent, such a "strike" could easily resume. Indeed, existing dollar investments could be withdrawn--thus making the situation much worse.

My colleague Stephen Marris has estimated that the huge capital inflows associated with a rising trade deficit in the early 1980s held real US interest rates 3-5 percentage points below where they would otherwise have been.[2] A loss of such inflows now, let alone a withdrawal of funds already here, could cause a rise of 3-5 percentage points in real interest rates. This would come in addition to the rise in nominal rates associated with the further pickup in inflation which would also accompany a further decline in the dollar, pushing the level of nominal interest rates well into double digits--certainly for longer maturities, perhaps for short-term paper as well.

2. Stephen Marris, Deficits and the Dollar: The World Economy at Risk, Washington: Institute for International Economics, December 1985.

Hence a "free fall" of the dollar could push the US economy into recession. The future trade gains which would result would only emerge after a year or so, and might not in any event offset the adverse effects of higher inflation and higher interest rates. Unfortunately, such a "free fall" now looks quite possible in light of the pessimistic outlook for alternative adjustment mechanisms.

The second peril is a major outbreak of trade protection. Such an outbreak could be triggered by the United States, if Congress passed clearly protectionist trade legislation (and overrode any Presidential veto) or the Administration sought to preempt such an outcome by adopting new protectionist devices itself a la President Nixon's import surcharge in 1971. The postwar history of US trade policy shows that dollar overvaluation and a large trade deficit are the best leading indicators of protection, because they dramatically alter the balance of our trade politics, so a failure to cut the trade deficit much further clearly risks such an outbreak. But a protectionist surge could also be triggered by European adoption of the Commission's proposed tax on vegetable oil (and hence on US soybean exports) or a perceived failure of Japan to truly open its market or via a number of other channels.

Growing protectionism has already eroded the world trading system substantially. On several occasions, notably the Adminstration's announcement of sanctions against Japanese semiconductors and House passage of the Gephardt Amendment, it has contributed to sharp falls in the exchange rates of the

dollar--thus increasing the prospects for the first peril, described above.

More fundamentally, any new protectionist surge would disrupt the entire trading system. By doing so it would raise major doubts about the economic future of all export-dependent countries, reignite the Third World debt crisis, and cast doubts on the basic structure of international economic cooperation by raising the specter of the 1930s. This latter effect would in turn have a very chilling impact on investment plans throughout the world, and even consumer confidence, and could thus turn a sluggish economic outlook into a full-blown downturn.

The third peril is a failure of the United States to launch a credible and sizable reduction of its budget deficits in the context of a falling trade deficit. A falling trade deficit of course means a decline in net capital inflow, even if foreign confidence in the dollar were fully maintained, because the two numbers must be identical. If the budget deficit remained anywhere near $180-200 billion, however, that reduced inflow from abroad would mean that total ex ante demand on our credit markets would far exceed the ex ante supply of funds. This could drive up interest rates and produce a recession as well.

In essence, the "crowding out" which was feared in the early 1980s could occur in the late 1980s. It was previously avoided because of the inflow of funds from abroad, keeping our real interest rates from soaring even further (as noted above) and thereby permitting the sharp recovery of 1983-84. We in fact now

know the miracle of supply-side economics: the foreigners supplied the money. But if they no longer do so, either because they lose confidence in the dollar (per the "free fall" scenario noted above) or simply because the trade balance declines and the associated capital inflow drops as well, this particular peril could also eventuate.

To avoid these first three perils, the United States must reduce its budget deficit by another $30-40 billion annually over the next three to four years. This would obviate the need for a further sharp fall of the dollar to restore equilibrium in the trade balance, yet help achieve such adjustment and thereby limit the risk of more trade protection. By directly cutting the demand for investible funds, it would reduce the risk of "crowding out." In all these ways, correcting the budget deficit offers by far the best prospect for avoiding extremely adverse outcomes for the US economy.

If the United States were to set its fiscal policy on such a path, however, the growth of world demand would be jeopardized. The United States would clearly be seeking export-led growth, to bring the current account deficit down and to offset the fiscal drag. Our domestic demand would probably grow quite slowly. It would certainly grow more slowly than our GNP, by the amount of the improvement in the trade balance, a reversal of the situation from 1981 through 1986 (which, as noted above, probably began with the fourth quarter of last year).

But this scenario leaves the key question of where the world economy will receive its growth leadership, and this poses the fourth peril--that the major countries abroad, notably Japan and Germany (as a proxy for Western Europe), will not move far enough fast enough to do so. In that case, the world economy will clearly slip into recession. Aside from the partial recent effort of Japan, there is little evidence that these countries are moving.

Fortunately, they are in an ideal position to do so:

-- their inflation rate is zero or negative;

-- their external surpluses are very large;

-- their budget deficits have declined to very low levels, particularly when compared with their very high rates of national savings (and thus ability to finance budget deficits);

-- unlike the United States, they have had no catchup growth spurts since the world recession of 1982;

-- hence their unemployment rates are as high as in the last recession, or even higher (as in Japan).

These countries need to adopt new expansionary measures quickly, mainly through tax cuts and other fiscal steps, to boost

the growth of their domestic demand by at least 2 percentage points for at least the next two years. This would maintain world growth at a respectable level, reducing the risk of added protectionist steps and a resurgence of the Third World debt crisis. It would also spur US exports by about $40 billion annually when the cumulative effects of such growth were complete, obviating the need for much of the dollar decline which would otherwise be required. Japan's new $43 billion program seems able to achieve about half of its portion of this target, if fully implemented, though it supplements the most restrictive budget in Japan in 30 years. Moreover, it must be noted that only about one sixth of Japan's two stimulus packages in 1986 turned out to provide additional demand.

Conclusion

The American and world economies face several risks of considerable magnitude. All these risks stem from the huge international imbalances which are the legacy of the opposite fiscal-monetary policy mixes of the major countries in the first half of the 1980s, and the huge disequilibrium in currency relationships which resulted. Further steps of substantial magnitude are needed to correct the imbalances, beyond the decline of the dollar to date and other policies already adopted.

The nature of these further corrections, as well as their magnitude, is crucial. A further sharp fall in the dollar, or "adjustment" via a US recession, or an outbreak of trade protection in this country, would create "cures" which were worse

than the disease.

It remains imperative to achieve the remaining correction via a credible reduction of the American budget deficit and a sharp pickup of growth abroad. Some further currency realignments may be needed, but in such a context could occur in an orderly manner. Such an outcome must be the major task of economic policy within the United States and abroad over the coming months. It is tragic that the Venice summit seemingly failed even to address the issues seriously, and time to avoid the four perils may now be running perilously short.

Senator SARBANES. Thank you. Mr. Jasinowski, please proceed.

STATEMENT OF JERRY JASINOWSKI, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. JASINOWSKI. Mr. Chairman, thank you very much for inviting me. I am pleased to be here along with my other distinguished colleagues.

Last night I was preparing my notes, and my wife said, "What are you testifying on today?" And I said, "The world economy." And she said: "Be humble."

And so I think that I would just start out by saying that we have, I think, a very broad canvas that we are dealing with today, and I think the committee deserves credit for taking on such a broad set of issues, and the testimony has been superior.

I agree with my colleagues, in large measure, but I would like to indicate that I disagree with Fred Bergsten on two points: One, in terms of the threat of protectionism as being very likely this year; and second, I do not see a recession in the short run. I think that the real threat has to do with debt escalation and the issues he raised in part of his testimony having to do with the longer term. I make these points to sharpen the extent to which the panel may be able to focus on agreement.

A large part of my disagreement with Fred Bergsten has to do with timing. These perils all could occur at sometime. In the next year, I see most of them as unlikely. The real peril is, as you move out a bit further, and that has to do with this growing international and domestic debt problems.

Let me break my summary of the testimony into two parts, Mr. Chairman—the good news and the bad news, given my introductory comments.

The good news has six parts.

First, over the last three quarters, there has been significant improvement in real net exports of approximately $30 billion. We have had a turnaround in the trade deficit measured in real net exports that is significant. This is in large measure a result of the devaluation that has occurred, which has made our exports more competitive abroad and slowed our import growth.

Second, this trade improvement has had, and will continue to have a favorable impact on GNP growth, reducing the drag on GNP growth of approximately $50 billion over the next 2 years, adding, as Fred Bergsten suggested, probably a percentage point to real economic growth and serving as a bridge over the second quarter, which has avoided our slipping into a recession. Quite frankly, there was not much going on in the American economy in the first quarter except for inventories and the beginnings of trade improvement, and right now, we are seeing a substitution for improvements on the international trade front for a weakening domestic economy.

The third positive point is that the combination of the lower dollar and improved corporate competitiveness has brought a substantial degree of improvement to particular industries on the export side, such as lumber and wood products, paper, chemicals,

some apparel and other price-sensitive commodity-like products. This is still another sign of manufacturing bouncing back in at least certain areas.

Point four. Having declined sufficiently to have improved our competitiveness, the dramatic decline in the dollar is now over. It seems to me that there are clear signs the dollar is beginning to stabilize, both because of the improvements on the trade front and interest rate dynamics.

That is not to suggest that the dollar will not decline further. I think it will, gradually, for reasons having to do with our poor current account position. But the notion of the dollar taking a dramatic plunge, I think has to be ruled out.

And in large part, that is so because the evidence on the capital flow side—and it is important to keep this in mind—that there is a very large attraction to the United States as an investment area. A lot of the money flowing into this country is not coming here just to buy U.S. Government securities, it is to buy American assets and to invest directly in. And much of this trend of capital into the United States is a positive flow, and we must distinguish between what are the positive and negative factors on the capital side, so that we understand fully the nature of that problem.

Finally, I think that the Congress will pass and the President will sign a tough trade bill, that clearly avoids protectionism, and I think the Congress deserves much of the credit for having moved this issue forward.

The bad news is I think also substantial. Despite the trade progress I have mentioned, we are not going to see dramatic drops in the trade deficit. We are looking at improvements in the trade deficit of only $15 billion to $20 billion in what is a very large trade deficit. The reasons we are not going to see improvements occurring dramatically is for several reasons, including:

(a) Slow growth abroad, as Fred Bergsten has suggested, resulting from the unwillingness of the Germans, in particular, to take more stimulative policies;

(b) Competitive pricing practices of an extraordinary nature by foreign corporations, where they are quite willing to accept even losses, in order to hold onto an American market share; and

(c) You find substantial trade barriers abroad, particularly in the Pacific Basin, Japan being a continued good example and South Korean another. In deed, the devaluation of the dollar has been highly uneven.

Mr. Chairman, I would like to stress that, despite all the positive improvements in the dollar's decline, with respect to competitiveness, that the German and Japanese currencies account for a little over a third of American trade. A substantial amount of American trade has not been improved at all by the dollar exchange rate changes that have occurred, whether or not you are talking about the Canadians or the South Koreans. And it is very important for us to keep our priority on exchange rate policy in these other areas.

That set of negative factors, which means that the trade deficit will not improve quickly, has the further secondary implication of saying that the picture on the current account is not very good.

There is no reason to believe that we are going to be able to see a substantial reduction in the current account.

I don't have precise estimates. My colleagues, some of them have estimated a $10 billion to $15 billion improvement, while I see the current account as flat for 1987. I see no particular signs that you will see much improvement

This brings me to my third point, which I think is the really big negative and the one that we all ought to be focusing on, and I think Fred Bergsten has, and I am sure that Bob Hormats will, as well, and that is the continued growth of U.S. indebtedness and dependence on foreign capital, which, as I stressed before, is not all negative, but a substantial part of the growing dependency on foreign capital to finance our budget deficits and to finance our debt service, is making the United States a permanent hostage to foreign capital inflow, which, in turn, is going to and is in the process rendering monetary policy obsolete as a means for controlling the American economy.

As long as we have current account deficits that are not showing sharp declines, even though I see no dramatic decline of the dollar falling out of bed, we will see continued pressure of the dollar. That means that the Federal Reserve will consistently have to take protecting the dollar as a major priority, something that is relatively new, in terms of economic policy, putting a much lower emphasis on encouraging domestic economic growth and permanently becoming a contributor to what has become a fairly stagnant growth pattern for the American economy.

I don't see, for the reasons that Fred Bergsten outlined, any easy way out of that dilemma, whether or not one looks at the alternatives of further rapid devaluation, recession or whatever, except for—and this brings me to my final point—there is no way to prevent this kind of stagnation and eventual recession, although I do not see that at all occurring this year. But we will have that stagnation and possible recession unless we begin to make a full commitment to competitiveness that has to do with everything from reducing the budget deficit to the passage of the trade bill and avoiding the kind of legislation that would impede our competitiveness, whether or not we are talking about obsolete plant closing, legislation or new mandated benefits, and, of course, continuing a major drive at the corporate level, where I think we have maybe moved 25 percent of the way, Mr. Chairman, in terms of being fully competitive. Now we have to move the other 60 to 75 percent in the corporate area, and we have to push for sensible public policies.

But I think—as I have thought about this problem of international competitiveness over the last couple of years, it comes down in many respects, Mr. Chairman, to values and attitudes, and we simply must put a higher value on everything we do with respect to being more competitive, if we are to avoid the kind of permanent stagnation and eventual recession that these international imbalances can cause. Thank you.

[The prepared statement of Mr. Jasinowski follows:]

PREPARED STATEMENT OF JERRY JASINOWSKI

EXECUTIVE SUMMARY

1. Over the last three quarters, there has been substantial and significant progress in real net exports, by $29.6 billion (in constant 1982 dollars) over the period 1986:4 through 1987:1. This favorable development, however, is tempered by the fact that in current dollar or nominal terms, the improvement in both total net exports and the narrower merchandise trade balance has been only minimal. Of these measures, we prefer real net exports on the grounds that it enters directly into GNP through the National Income Accounts, and is therefore a better gauge of the impact of external trade on aggregate output.

2. There are two major causes of the improvement in net exports. The devaluation of the dollar since early 1985 has augmented the relative price position of American goods in global markets as well as relative to imports in the domestic market. Simultaneously, the slackening of demand in the United States has depressed imports.

3. Notwithstanding the devaluation of the exchange rate, export gains will be minimal over the next two years due to slow growth overseas. Because of the obdurate refusal of Germany and to a lesser extent Japan to reflate, the rest of the world will experience only very sluggish rates of expansion, and this will depress demand for American exports.

4. Assuming relatively slow growth here and abroad, with the dollar falling only slightly further relative to its current levels, NAM projects an improvement in real net exports of $25 billion (constant 1982 dollars) in 1987 and 1988. This will come both from import reductions and increased exports.

5. Although the prospects are for continued improvements in net exports, there are several mitigating factors that will inhibit a more rapid improvement on the trade front. These include:

o Microeconomic factors — attempts by foreign corporations to preserve their share of the American market by pricing competitively, even at the cost of lower profit margins.

o Barriers to entry. Any number of foreign countries have continued to engage in de-facto protectionism through the use of non-tariff barriers that have denied American firms access to local markets.

o The fact that the devaluation of the dollar has been uneven, with exchange rates still overvalued against the currencies of many of the Less Developed Countries and the newly industrializing countries of the Pacific Basin.

6. While the dollar can be lowered selectively against the Third World country currencies and Canada, from the standpoint of domestic economic stability it is generally considered desirable to prevent a precipitous fall in the dollar. The reasons have to do with the Federal budget deficit, which cannot be financed through domestic savings alone without crowding out private sector borrowing. Currently, about 14 percent of Federal borrowing consists of foreign purchases of Treasury securities; the financing of the government deficit accounts for more than 40 percent of foreign investment in the United States. In order to insure some continuation of capital inflows, the dollar must be kept relatively stable against the currencies of the other large industrial countries. An excessively rapid depreciation would lead to both higher interest rates and higher inflation, and for this reason would augment the risk of recession in the United States.

7. The major policy initiative necessary to insure both continued improvements in trade and greater macroeconomic stability is budget restraint. At the same time, a limited amount of intervention can be used in foreign exchange markets to achieve a stable value for the dollar and prevent speculative disturbances.

RECENT IMPROVEMENTS IN TRADE

As of early 1987, it has become clear that the deficit on net exports has finally passed its peak; it will now decline in real terms, and probably in current dollar terms as well. This prognosis is considerably more optimistic

than the current dollar trade figures would suggest, since the merchandise deficit in April showed only very minimal improvements. However, these figures are misleading for two reasons. First, they do not include services, which are an important component of aggregate overseas transactions. The United States has consistently run surpluses on its service accounts, and when services are added to merchandise trade, the overall trade accounts have frequently shifted from negative to positive. Secondly, the merchandise trade accounts are expressed in nominal dollars; we believe that the constant dollar estimates are preferable. In our view, therefore, the optimal measure of external trade is net exports in constant dollars, derived from the National Income Accounts. This series is computed by converting exports and imports to inflation-adjusted 1982 dollars and taking the difference. This measure more closely approximates the physical volume of goods and services traded; it is a real magnitude which includes services, and it is also a direct component of GNP. In this respect, it is real net exports rather than nominal merchandise trade which determines the contribution of the external sector to aggregate output. Another factor to be borne in mind is that real net exports is less subject to distortions caused by exchange rate realignments. Changes in exchange rates frequently have perverse effects on nominal trade flows, inasmuch as they raise and lower the export and import price deflators; this is obviously not a problem, however, after adjustment for inflation.

Quite apart from its conceptual superiority, net exports constitutes a better measure of trade flows inasmuch as it more closely reflects the major changes in American competitiveness. For instance, it is generally well-established that the dollar was chronically overvalued during the Bretton Woods era (1946-71), but that the successive devaluations in 1973 and 1978-80 led to significant improvements in this country's trade position. Net exports fully reflect these developments. The real net exports series show persistent deficits from the late 1950s to the early 1970s, but surpluses in the years following devaluation (1974-75 and 1979-81). By comparison, the nominal

merchandise trade balance shows consistent surpluses during the Bretton Woods era and nearly consistent deficits thereafter. What this means is that the behavior of real net exports is closer to what would be suggested by international trade theory than is the behavior of the nominal merchandise deficit.

Using the real net exports series, several developments are immediately apparent. First, the deficit reached its apex in 1986:3, at -$163.3 billion, and has declined sharply since this time. In 1986:4, net exports improved by $15.3 billion to -$148.4 billion, while in 1987:1 a further improvement of $14.3 billion to -$133.7 billion took place. The recent trade data also appear commensurate with the prognosis that the second quarter will also witness an amelioration in the trade accounts. This would represent three continuous quarters of steadily declining deficits on net exports, by fairly large magnitudes. In sum, a positive trend in real net exports is beginning to emerge. It should be noted here, however, that this has not been true of the nominal data. In nominal terms, the deficit on net exports went from -$108.9 billion in 1986:3 to -$110.2 billion in 1986:4 and -$107.9 billion in 1987:1.

This favorable development in real net exports is to be expected, given recent shifts in the fundamental determinants of trade flows. The dollar has declined sharply against the currencies of the other major industrial nations since early 1985, with the result that vis-a-vis Europe and Japan most of the effects of the prior exchange rate appreciation of 1981-85 have now been reversed.

At the same time, demand in the United States has begun to slacken. In 1987:1, personal consumption expenditures declined at an annual rate of -$7.0 billion, while spending on durables fell by -$20.4 billion. At the same time, business fixed investment declined by -$11.5 billion. In the absence of the first quarter inventory building, the domestic components of GNP would have

been negative. In other words, the weakness of domestic spending is reducing demand for imports.

The pattern of improvement in net exports has, however, shown some differences on a quarter to quarter basis. The improvement in 1986:4 was accounted for solely by a massive surge in exports, while in 1987:1 there was an increased contribution from import reductions. More specifically, in 1986:4 real exports surged by 16.7 percent while imports fell by -0.7 percent. By comparison, in 1987:1 exports increased by 11.8 percent while imports declined by -3.5 percent. This leaves some doubt as to whether the trade improvement will be predominantly export or import led. To attempt to resolve this issue, it is necessary to examine growth rates overseas and their determinants.

GROWTH RATES HERE AND ABROAD

One of the disappointing results of the recent Venice economic summit was the failure of a consensus to emerge on stimulating higher world growth. Apart from some unenforceable and largely ineffectual agreements about improved coordination of economic policy, the United States was not able to extract any commitments for more stimulative macroeconomic policies. In particular, Germany rebuffed the American request that it adopt a more stimulative monetary and fiscal stance, although Japan has taken some steps toward a looser fiscal policy.

German policy makers have argued they should not be obligated to bail out the United States for its inept fiscal policies, and that the adjustment of international trade accounts should take place through greater American fiscal restraint. The obstinate refusal of the Germans to loosen may be motivated by the memory of the late 1970s, when their agreement to reflate in deference to American wishes led to an acceleration in inflation. More specifically, then-Chancellor Schmidt agreed to a package of stimulative measures at the 1978 summit at the request of President Carter, only to be confronted the following

year by the second OPEC crisis and a doubling of the inflation rate. The German government, now led by a conservative coalition, and the semi-autonomous Bundesbank, which is notoriously orthodox in its macroeconomic views, are determined not to repeat this experience.

It should be emphasized here, however, that the experience of 1978-79 does not constitute a reasonable basis for comparison. In the late 1970s, the world economy was experiencing a major buildup in inflation and markets were relatively tight, while at the current time there is widespread slack in global markets and conditions are generally disinflationary. Moreover, Germany has experienced zero and in some instances negative inflation for the last two years, giving this country adequate room to loosen without any fear of price instability. Consequently, Germany's policy position cannot be viewed as justified under the present circumstances.

Nevertheless, this policy decision has substantial implications for the world economy. Because Germany is the dominant economic power in Europe and because the other EMS currencies are linked to the mark, Germany's consistently restrictive demand management policies imply similar policy conservatism throughout the EEC. Since any country which reflates is likely to face a balance of payments deficit and the potential decoupling of its exchange rate from the mark, the European community as a whole is likely to emphasize inflation control and follow the route of orthodoxy in demand management.

In Japan, policies may be gradually shifting toward a looser fiscal stance. Up to now, the prevailing consensus in this country is in favor of a policy mix consisting of mercantilistic trade practices and restrictive management of domestic demand. While the initial moves toward fiscal stimulus are only tentative, it must be borne in mind that policy making in Japan typically takes place quite slowly inasmuch as leadership in this country essentially collegial, with a great deal of decision-making authority concentrated in ministries and parastate buresucracies which are outside of

Prime Ministerial control. There is some evidence, however, that Japanese leaders are increasingly aware of the fact that they cannot continue to rely on exports to the degree that they have in the past. Further, there are any number of domestic priorities in Japan such as inadequate infrastructure and an outdated housing stock that will have to be addressed through higher government spending. Notwithstanding this improvement in the Japanese willingness to cooperate with its trading partners, it is still unclear to what extent major policy changes will take place in this country, and what effects they will have on the trade deficit.

Given the reticence of Germany and Japan to apply stimulus, the outlook overseas is for slow growth. The June 1987 European Community forecast for the industrial countries shows real GNP advancing by only 2.7 percent in Japan and 2.2 percent in the EEC for the remainder of the year, while European growth rates are projected to remain in the range of 2.3 percent during 1988. Meanwhile, growth rates in Latin America should be minimal inasmuch as the persistent external debt burden is forcing these countries to adopt cautious demand management policies and emphasize exports. The result is that global demand for American exports will remain very weak.

While the implied path of exports is therefore relatively sluggish, the trade outlook will benefit from the anemic growth rates of domestic demand in the United States. Consumer spending will be held back by high interest rates, unusually high personal debt loads, the depletion of savings, and slow growth in disposable income. The most recent NAM forecast shows personal consumption expenditures growing by only 1.6 percent in 1987 and 1.5 percent in 1988. Therefore, even though there will be comparatively little growth in demand for American exports, weak demand in this country will mean a slowdown in imports, imports, especially if foreign goods become less competitive because of exchange rate changes.

NAM TRADE PROJECTIONS

Based on the above considerations, NAM projects an improvement in real net exports of approximately $25 billion (in constant 1982 dollars) in both 1987 and 1988. The forecasted values for real net exports are as follows:

CATEGORY	1986	1987	1988
Net Exports	-147.8	-124.1	- 97.2
Exports	371.5	389.8	413.9
Merchandise	207.4	218.7	231.1
Agriculture	30.0	34.0	36.9
Services	134.1	137.1	147.8
Imports	519.3	513.9	511.1
Merchandise	343.8	339.7	336.0
Petroleum	74.7	76.3	77.8
Services	100.8	97.9	97.3

All figures: Constant 1982 Dollar Billions

The pattern of the improvement that is projected here relies on modest but continuous gains in exports, coupled with slow reductions in the real import volume. This letter development is distinctive in that imports normally rise continuously during business cycle expansions, and only decline in real terms during recessions. For instance, the improvement in the trade accounts following the devaluations of 1973 and 1978-80 was based primarily in increasing exports, although the net export surpluses recorded in 1974-75 were caused by the shortfall in demand for imports engendered by the recession of the mid-1970s.

Developments in world oil markets introduce an element of uncertainty into the trade forecast. Some of the massive swings in net exports reported over the last year have been due to speculative volatility in oil markets. For instance, imports were higher than expected in late 1986 due in part to precautionary stockpiling of petroleum, while imports fell in early 1987 in part due to liquidation of surplus oil stocks. While much of this speculative volatility may now be at an end, there are still uncertainties with respect to petroleum imports due to recent increases in spot market prices. The previous collapse of OPEC prices and the resultant capping of American oil wells in the Southwest has made the United States more dependent on oil imports. Consequently, with oil prices now in the range of $18 to $20 a barrel, the nominal trade deficit may fail to improve in 1987 due to the higher current dollar price of petroleum. However, this should not affect the real volume of oil imports. NAM's estimate of a 2 percent increase in real oil imports in 1987 is actually somewhat higher than estimates obtained by other forecasters.

IMPLICATIONS FOR GROWTH

The projected improvements in trade will be the critical factor in avoiding recession. NAM's forecast is for slow growth without a recession in large measure because the better trade performance will "bridge over" periods of domestic weakness.

The first quarter GNP figures were misleading inasmuch as the heavy buildup in inventories has masked weaknesses in domestic demand. The sources of weakness include the rise in interest rates during the first quarter, the contractionary implications of tax reform with respect to capital investment, and the erosion in disposable personal income caused by the rise in the inflation rate, coupled with high personal debt loads. The impact of these factors is by no means negligible: even with the improvement in net exports, GNP would have declined by -$25.7 billion in the absence of the inventory buildup.

The preliminary data for the second quarter is mixed, and points to a continuation of expansion, albeit at a more moderate pace. Industrial production fell slightly in April but recovered strongly the following month. However, in April and retail sales declined; this latter development is cause for concern inasmuch as weak consumer spending could lead to the emergence of an overhang of unsold inventories by the second half, creating the preconditions for a stock liquidation cycle. A more positive series of developments is that the adjustment of capital spending to tax reform may have largely played itself out in the first quarter, while the monthly merchandise trade numbers for May showed a continuing drop in imports. Meanwhile, the jump in the inflation rate in the first quarter has now resolved itself on a transitory aberration caused by relative prices. Bearing this in mind, the only major sources of growth in the second quarter are likely to be inventories and the lower trade deficit, with GNP projected at between 1 and 2 percent.

Beyond the second quarter, domestic demand should strengthen, and our current projections are for growth rates of 2 percent in the second half of this year and in 1988. These growth rates are less than robust, reflecting the gradual exhaustion of the dynamic processes underlying this recovery; nevertheless, the trade sector seems to be the key factor responsible for preventing an actual recession, and in this respect the reduced deficit on net exports reduces the drag on GNP by roughly $25 billion per year.

FACTORS MITIGATING THE TRADE IMPROVEMENT

The above analysis relies on econometric procedures which model trade solely as a function of relative prices adjusted for exchange rates and international differences in aggregate demand; as such it does not take into account microeconomic factors at the industry and firm level that may impact on trade flows. In this respect, three factors may mitigate the favorable trade developments.

First, foreign suppliers are likely to attempt to hold onto their share of

the American market by pricing their goods in an unusually competitive fashion. As pointed out in a recent Federal Reserve study, many foreign firms possess considerable scope for discretionary price cuts as a result of the larger profits they enjoyed during the recent period of dollar appreciation. Because of the magnitude of the earlier appreciation of the dollar, foreign corporations experienced a substantial and largely unanticipated expansion of their profit margins. This in turn gives them leeway to reduce profits by lowering prices in order to compensate for the dollar's devaluation.

Secondly, any number of foreign countries are still limiting market access to American goods. Particularly in Japan and in the Pacific Basin, any number of non-tariff barriers have been used to keep American goods out of local markets. It is only recently that the newly industrialized Pacific nations, such as Taiwan and South Korea have begun to increase their purchases of American goods, and largely out of fear of retaliatory protectionist measures. Notwithstanding recent efforts on the part of these countries to reduce their trade surpluses, however, formidable barriers to entry remain, ranging from state-run industrial policies which give preferential treatment to domestic firms to regulatory requirements and nationalistic sentiment on the part of foreign consumers.

Finally, it should be noted that the devaluation of the dollar since early 1985 has been asymmetric with respect to foreign countries. Most of the devaluation has taken place against Japan and the EMS currencies. However, these countries now only account for about 36 percent of American trade. Against Canada, which accounts for some 20 percent of trade, the American dollar has fallen little. The dollar has actually appreciated against some of the weak currencies of debt-ridden Latin American nations. Against the newly industrialized Asian countries, the dollar has declined only very minimally. Taiwan has revalued against the dollar during the last twelve months, but South Korea's exchange rate has undergone only minimal appreciation. The current American pressure on Japan may induce South Korea to revalue further. Until

the exchange rate is bilaterally adjusted against individual trading partners, however, the United States will continue to be in the position of being selectively overvalued.

FOREIGN DEBT, GLOBAL CAPITAL FLOWS AND THE DOLLAR

While from the standpoint of trade flows a further depreciation of the dollar would be in order, at least against individual countries, it should be noted that there are other reasons why only a gradual and orderly devaluation should be permitted. The reasons have to do with the threat to stability in the United States posed by the international capital flows that would ensue in the event of a precipitous decline in the exchange rate.

Consider the effects of a sudden loss of foreign confidence in the dollar. Foreign investors would respond by repatriating their short-term liquid assets so as to avoid the losses that would result from devaluation; however, the remission of assets would in and of itself cause the dollar to fall, making fear of devaluation a self-fulfilling prophecy. These developments would entail two serious problems for American policy makers. On the one hand, the flight of capital would make it necessary to finance the fiscal deficit through domestic rather than foreign borrowing; on the other, the fall in the dollar would raise the inflation rate. In the event that the deficit were financed through additional money creation, excess liquidity and the depreciating dollar would rapidly drive the inflation rate to prohibitive levels.

Estimates of the effects of the exchange rate on inflation remain a source of controversy. Several econometric studies have indicated that the successive realignments in the dollar from the mid-1970s onward exerted a substantial impact on domestic price movements. The depreciation of the dollar in 1978-80 is estimated to have raised inflation by just under two percentage points, while the appreciation of the dollar in 1981-85 is estimated to have lowered inflation by approximately 2.5 percentage points. Based on some early NBER studies, the elasticity of the inflation rate with respect to the exchange rate

is in the range of -0.1 (meaning that a 10 percent change in the exchange rate would change inflation in the opposite direction by 1 percentage point). However, this estimate appears to be somewhat too high in the current economic environment. During the late 1970s, when labor and product markets were tight, domestic producers responded to increases in import prices caused by the depreciating dollar by corresponding price increases in domestic goods; this meant that the exchange rate tended to feed through into the domestic inflation rate directly, through price arbitrage. By comparison, at the current time there is sufficient slack in labor and product markets to prevent this from taking place. Hence, devaluation is likely to induce substitution into domestically-produced goods, and will not be fully reflected in the inflation rate. Consequently, NAM computed estimates of the elasticity of the inflation rate with respect to the exchange rate using different equation specifications and alternative time periods. Our best estimates are in the range of -0.08 over a one year interval, yielding a weaker relationship than cited above, but by no means a negligible one.

This implies that there is still some room for further devaluation of the dollar before the United States would have to confront a serious threat of renewed high inflation. Nevertheless, policy makers clearly cannot allow a "depreciation crisis" to emerge. In the event that the dollar were to fall by substantial magnitudes, for instance by an additional 20 percent, monetary policy would have to be tightened to support the exchange rate. The combination of tight money, capital flight and the pressure in credit markets caused by the budget deficit would induce a substantial rise in interest rates. Under these conditions, the economy would collapse into recession, with particularly severe output losses visible in interest-rate sensitive sectors. Parenthetically, it is worth noting here that in this eventuality, the lower dollar and the decline in domestic demand would combine to reverse the deficit on net exports; somewhat paradoxically, the country could actually solve much

of its trade problem, but only at the expense of greater output losses in other areas.

What has happened over the last six months can be viewed as a mild version of this type of scenario. The dollar fell sharply in the first quarter, leading to a rise in interest rates of as much as 100 basis points. However, the resulting tightening of monetary policy effectively stabilized the exchange rate and prevented any widespread capital remissions. Once financial markets were calmed, the rise in interest rates was also halted.

Nevertheless, serious problems remain with respect to the external sector, having to do in particular with the financing of the American fiscal deficit. The deficit in FY 1988 is likely to exceed the Gramm-Rudman targets by upwards of $30 billion, and this will require further financing through reserve inflows. In order to generate these reserve inflows, however, the dollar will have to remain relatively stable against the currencies of the rentier nations that are currently investing in Treasury bills; Japan, the United Kingdom and West Germany. If the dollar falls against these currencies, an increasing share of the deficit will have to be financed domestically, thereby crowding out private borrowers.

In this sense, the period in which it was possible to simultaneously have large fiscal deficits and sustained growth in capital spending may now be drawing to a close. It was possible to finance both public sector and private borrowing during the early 1980s only by capital imports; this meant in essence that the fiscal deficit did not crowd out domestic capital spending only because (if one may employ somewhat unusual phraseology) it was crowding out net exports. What is meant here is that because the fiscal deficit draws in reserves, it has kept the dollar higher than it otherwise would be. In addition, the fiscal deficit has crowded out net exports by diverting funds from the spending stream overseas, thereby lowering foreign demand for american goods. If the dollar declines further, however, the fiscal deficit will increasingly crowd out domestic capital formation.

Nevertheless, a situation of continuous borrowing from abroad in order to finance the fiscal deficit is also unsustainable in the long-term, since it implies a continuous escalation in the external debt. As of 1986, the net external investment position of the United States stood at -$263.6 billion, an increase of $151.7 billion over the previous year. The United States has been able to incur net debtor status without a collapse in its exchange rate only because of its unique position as the world's reserve currency country; since the dollar is accepted as a medium of exchange worldwide, and since the debt is denominated in dollars, the United States enjoys the luxury of being able to to pay its debt by issuing reserve currency, rather than by generating additional exports. This does not mean, however, that net debtor status is not without danger. At some future time, foreign countries may resist further importation of dollar liquidity or may demand higher rates of return on dollar-denominated investments. This would lead to a rise in interest rates in the United States, with the same recessionary consequences as noted above. In this sense, the net-debtor status of the United States heightens the long-term risks facing the economy, and underscores the fragility of the current business cycle expansion.

CONCLUSIONS

On balance, the outlook for trade is currently much more favorable than in the recent past. Even without further policy changes, the external deficit has past its peak, and will decline over the next few years. However, in order to achieve a more lasting improvement in trade and at the same time insure greater domestic macroeconomic stability, a shift toward a more restrictive fiscal policy is necessary.

At first sight, it might appear counterintuitive to advocate fiscal restriction as a means of improving the trade accounts, given that the links between the government budget and trade flows are exceedingly indirect. Nevertheless, while indirect, they are quite powerful. Two channels of causality should be noted, the tendency on the part of the deficit to stimulate

capital inflows and thereby crowd out net exports (see above), and its corresponding tendency to stimulate consumption. Econometric estimates have indicated that when indirect causal channels are taken into consideration, the overly expansionary fiscal stance of the 1980s may have been responsible for as much as one half of the deterioration in the trade accounts. A shift toward a more contractionary fiscal policy would reduce the need for capital imports, while at the same time lowering domestic consumption; both of these factors would ultimately translate into a diminution of imports and a proportionate increase in net exports.

We believe that the primary impetus for fiscal restraint must come from reductions in outlays. During the early 1980s, Federal spending has drifted up to about 25 percent of GNP, well above the levels witnessed during the 1970s, and we believe that it should be reduced back to a lower share of GNP over the long-term, eg. 21 percent. Federal spending actually averaged slightly less than 21 percent of GNP in 1970-79.

On the tax side, it should be emphasized that the recent reform of the tax code will hamper any improvement in the American trade position. The underlying thrust of the tax reform bill was to lower taxes on consumers, whose marginal propensity to import is relatively high, while paying for these reductions by deleting investment incentives. Consequently, tax reform is likely to shift the output mix toward consumption, thereby drawing in imports, while at the same time raising the user cost of capital by as much as 20 to 25 percent. The increase in the cost of capital will slow down investment spending in exporting and import-competing industries, thereby retarding the productivity gains that would be necessary to achieve a comparative advantage in price.

Because of the potentially deleterious implications of tax reform for international trade, we also think that Congress should consider the beneficial results that can be obtained by replacing revenues from the existing Federal income taxes with revenues from a consumption-based tax. In addition to

providing a more favorable climate for capital investment, this would also shift the output mix away from consumption. Moreover, consumption taxes also tend to discourage imports by raising the prices of imported goods. The experience of the value-added tax in Europe corroborates the view of favorable effects on trade.

A third policy initiative that should be given consideration is the continued use of limited intervention in foreign exchange markets in order to achieved desired paths for exchange rates. The initial Baker plan in 1985, whereby the largest industrial countries agreed to intervene against the dollar, was instrumental in achieving the devaluation of the last two years. More recently, intervention has been used in order to prevent a collapse in the dollar. As noted above, limited intervention could also be used to bilaterally realign the exchange rate against the currencies of countries such as South Korea and Taiwan, which have avoided any appreciation by virtue of the fact that their governments have intervened to peg them to the dollar. Intervention, of course, is not a substitute for changing the fundamental determinants of exchange rates, which have to do with macroeconomic policies across national boundaries. Nevertheless, the recent record of limited intervention has been sufficiently successful that it should be used systematically in order to prevent or counteract speculative disturbances in foreign exchange markets.

With respect to stimulating more rapid growth abroad, there is little that can be done other than what is being done already. Continued pressure on Germany and Japan, both through official diplomatic channels and through informal channels such as the media may be effective in inducing these countries to adopt a more stimulative posture in demand management. The possibility that these countries will experience a further growth slowdown in 1988 actually enhances the likelihood of a shift to looser fiscal policies.

Finally, as NAM has stressed repeatedly in the past, much of the improvement in trade will ultimately have to come from the private sector. There is now increasing evidence that American industrialists have become more highly sensitized to the need to compete with imports and the need to sell more aggressively in foreign markets. The increases in manufacturing productivity over the last few years will also have beneficial effects on the trade balance in manufactures. It is up to Congress to create a stable economic environment and avoid creating new burdens for industry, for instance through mandated benefits, so as to enable the private sector to compete more effectively.

Senator SARBANES. Thank you very much. Mr. Hormats, please proceed.

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN SACHS & CO.

Mr. HORMATS. Thank you, Mr. Chairman. My colleagues on the panel have covered a number of issues, so I will try to be brief and focus on a few major points.

The first is that the U.S. economy is in the midst of a transition. For the last few years, it has been driven by stimulative fiscal policy and strong domestic demand and sapped by deteriorating trade balance. Now an improving trade balance is a source of strength in the American economy, supplementing sluggish growth in domestic demand.

I will send the committee staff some of the excellent economic work that has been done by our economists at Goldman Sachs, on which my figures in this testimony are based. But I want to highlight a couple of numbers that illustrate this transition very vividly.

Between mid-1984 and mid-1986, real domestic demand in the United States increased at a 3.3 pecent annual rate, but real GNP rose at only a 2.5 percent rate, nearly 0.8 percent was lost by a deteriorating trade balance. Since the third quarter of 1986, net exports have contributed 0.7 percent to growth in U.S. production instead of subtracting 0.8 percent. Thus, although domestic demand from the second quarter of 1986 through the first quarter of 1987 rose at only 2 percent rate, GNP grew at a roughly 2.7 percent rate, due to the boosts provided by improved net exports.

That turnaround is particularly important. Now growth is beginning to be stimulated rather than sapped by exports.

Senator SARBANES. Let me just interject that in our annual report of the JEC, we, in fact, had a table that showed GNP movement and this line above it is domestic consumption, which, of course, is the very point you are making.

Mr. HORMATS. Very much along those lines. And I think it is an important way of looking at the transition.

Let me make a couple of points about the impact of the dollar's decline. First, the point was made by Secretary Baldrige, and I think it is an important one to recognize, that foreign suppliers have tried to hold their share of the American market by taking big cuts in profitability. Our experts have put these figures together. Their basic judgment is that profits on exports to the United States from its major suppliers have dropped to a 15-year low, which means that large numbers of producers abroad are now sacrificing profits to retain American market share.

We also have to operate under the assumption that they can't do this forever, and if the dollar stays where it is, or goes down further, they are squeezed more and the possibility of their raising their prices in the United States and, therefore, improving the price competitiveness of American goods, increases.

We have already seen import prices go up at roughly 10 percent. If foreign suppliers regain at least a portion of their former profitability, they will probably have to raise prices substantially more

than that over the next couple of years, and obviously, this means we are going to get a higher rate of domestic inflation as a result of foreign suppliers increasing the prices of the goods they sell in the United States.

People don't like a higher rate of inflation, but it is important to recognize that it is through higher import prices that American products regain a portion of price competitiveness and so inflation, or a little bit of inflation, is part of the price to pay for this trade adjustment.

And what we are seeing is, as Secretary Baldrige indicated, some—indeed, some substantial—improvements in volume, relatively flat imports and rather dramatic increases in exports in certain types of products, particularly industrial new materials.

Now let me talk a little bit about the dollar just to illustrate the problem. People have talked about the wonderful stability we have had as a result of the Louvre agreement. Fred Bergsten has put his finger on one aspect. That is, a lot of intervention has taken place. To be sure, the improvement in U.S. trade had helped to stabilize the dollar, but one number should be borne in mind. The interest rate differential between long-term United States and long-term Japanese bonds increased from 200 basis points early in 1987 to about 560 basis points early in June. It has since fallen back to about 475 basis points. And this basically means that the reason there is some private buying of American bonds—these are 10-year bonds in this example, because they are comparable with Japanese bonds—is that we have just had a big increase in interest rates. If this trend continues, and if the U.S. external debt problem continues, we may see much higher interest rates in this country to attract more money into the United States.

That, of course, means slower growth, if it continues for a long time.

The other point that is important to recognize is the sort of mirror image of the point I made with respect to the United States. As exports have contributed to growth in the United States, they have also provided a drag for the other OECD countries. And the numbers here indicate that.

For the OECD trading partners of the United States, in 1984 and 1985, domestic demand grew at 2.8 percent and increasing exports contributed 0.7 percent to their GNP's for a total growth rate of 3.5.

In 1986, domestic demand in these other OECD countries grew at 3.5 percent, but trade deterioration subtracted 1.2 percent from their GNP's, leaving growth at 2.3 percent. And it seems to me that the argument we ought to make is not that they ought to stimulate their economies to help us, it is that they ought to do it for good self-interested reasons. That is, the big trade turnaround that Fred Bergsten and Jerry Jasinowski have talked about is going to mean more of a sapping of their domestic growth by a turnaround in their trade. They have to stimulate their economies, simply to offset the trade deterioration resulting from the change in trade positions.

The serious problem is that other nations may not have fully considered the impact on their economies of trade adjustment needed to improve international trade balances.

And cumulative miscalculations, reinforcing one another and added to the Third World debt problem, could lead to a serious global slowdown, unless domestic measures are taken in these other countries to correct it.

Now I would leave the committee with one last general thought, because time is short.

Today we are in the midst of the second great transition of international economic power in this century.

In the beginning of the century, it was from Britain to the United States. The United States didn't quite know what to do with that power. Instead of advocating open markets, it advocated protection. It took almost too long for us to decide to defend our allies. We didn't realize how important our strategic power was and the responsibility it entailed.

The postwar order is based on the primacy of American power, both economic and political. Other countries have experienced a surge in their financial and commercial power. The problem now is to shift responsibility in parallel with this shift in power, and that means that other countries can no longer assume that the United States is going to forever order its policies so as to insure a healthy world economy, while its trading partners, perceiving themselves as less responsible for the world economy, pursue policies aimed at purely domestic goals.

It means that the Western Europeans and Japanese have to assume coequal responsibility with the United States for the health of the world economy, and that means increasing their growth rates with a mind toward better balance, and particularly, it means with respect to the Third World debt issue, that these big capital accumulators have to find means of rechanneling that capital, primarily through their own government's incentives, to worthy projects in the Third World.

That is important, because it keeps the recycling process going. It is also very important for dealing with our own external balances, because these countries of the Third World were big growers in the last decade. They are constrained now by financing in this decade. And with this sort of capital flow shift that I am talking about, there would be a boost for American exports. It is not a panacea, but yet another contribution.

So I would simply conclude by saying that, in addition to dealing with our budget deficit, and I haven't touched that, because it has been eloquently described by colleagues, that it is important to explain to other countries that it is in their interest to offset a deteriorating trade position by more stimulus. They also have to understand they have a broader role in the world economy today and a broader responsibility because of their economic strength. And they have to do something about capital flows to make sure that they are used in a constructive say over the medium term.

Thank you very much.

[The prepared statement of Mr. Hormats follows:]

PREPARED STATEMENT OF ROBERT D. HORMATS

1987 MIDYEAR REVIEW OF THE ECONOMY

Mr. Chairman and Members of the Committee:

I am grateful for the opportunity to testify at this hearing precedent to the Midyear Report. I will briefly address four points which I believe to be central to consideration of the relationship between the international economic outlook for this nation and its domestic economic prospects. These are:

-- the effect of recent trade improvements on the US economy;

-- US trade prospects in coming years;

-- the outlook for the dollar;

-- what we have been, and should be, doing internationally.

THE EFFECT OF RECENT TRADE IMPROVEMENTS

The US economy is the midst of a transition. For the last few years it has been driven by stimulative fiscal policy and strong domestic demand, but sapped by a deteriorating trade balance. Now an improving trade balance is a source of strength for the American economy, supplementing sluggish growth in domestic demand.

Between mid-1984 and mid-1986 real domestic demand in the US increased at a 3.3% annual rate, but real GNP rose at only a 2.5% rate. Roughly .8% was lost by a deteriorating trade balance. Since the third quarter of 1986, net exports have contributed .7 % to growth in US production instead of subtracting .8%. Thus, although domestic demand from the second quarter of 1986 through the first quarter of 1987 rose by only 2%, GNP grew at 2.7% due to the boost provided by exports. An improving trade balance is likely to continue to contribute to improvements in US growth for at least the next two years.

EXCHANGE RATES

The major reason for this improvement in America's trade balance has been the dollar's roughly 40% decline since February 1985, or 30% from the average of 1985. It is useful for reasons I will cite shortly, to review the process by which currency changes affect imports.

The first impact is on profit margins of foreign producers exporting to the United States. Some producers have increased the dollar price of products sold in the US in order to restore at least a portion of previous profit margins. But many have not. Profits on exports to the US from its major suppliers have dropped to a 15 year low, which means that large numbers of producers abroad are now sacrificing profits to retain American market share. Assuming that they cannot sustain low profits indefinitely, they will have to increase prices in the US enough to return to more traditional profit levels, ie about 15-20% from levels of mid-1987.

The second impact is on import prices. These prices have been rising at a nearly 10% annual rate (excluding petroleum) due to the fall in the dollar since early 1985. If foreign producers up their prices further in order to restore at least a portion of lost profitability, import prices should rise at a 10-15 percent annual rate over the next two years. It is particularly important to recognize the inevitability of such price increases, because they are the primary vehicle whereby American-made products can regain price competitiveness vis a vis imports.

These import price increases, of course, spill over into domestic inflation. Assuming a 10% increase in import prices ultimately translates into a roughly 1% increase in prices and wages in the goods sector, and that leads to a roughly .5% price increase in the services sector, then the expected import price increases should increase the CPI by an annual rate of .50% to .75% over the next 18 months. That, in effect, is the price to be paid for improving the US trade balance. It must be borne in mind that the strong dollar of past years contributed to lower US inflation, so some degree of higher inflation must be expected from the dollar's decline. The danger is that domestic producers will seek to increase domestic prices to match dollar for dollar the rise in import prices. That, of course, would lead to a sharper increase in inflation and thwart the trade improvements expected from the dollar's decline.

This leads to the last impact -- on volume. The ultimate test of success of the dollar's decline is in trade volumes. Merchandise trade imports (excluding petroleum), which increased from a $308 million annual rate (in 1982 dollars) in the third quarter of 1985 to $349 in the third quarter of 1986 have stabilized an an annual rate of $356 million in 1987. At the same time, exports have risen from an annual rate of $239 in the third quarter of 1986 to an annual rate of $270 billion in April 1987. Specifically, in the most exchange-rate sensitive area, industrial supplies and materials such as paper, chemicals and synthetic fibres (which are sold in bulk, homogenous, and thus very price sensitive) there has been a more than 10% increase in exports and only a 2% rise in imports since mid-1986. Exports of capital goods have increased by 8%, while imports have grown at less than 6%. Consumer goods, which are relatively less price sensitive, more taste-driven, and readily available from countries whose currencies have not appreciated as much vis a vis the dollar as the yen or deutschemark have continued to show a deteriorating balance.

THE DOLLAR

Much debate has focussed on the proper value of the dollar.The Louvre Agreement (February, 1987) sought to stabilize the dollar at roughly 140 yen and 1.80 DM, range. It has been remarkably successful in doing so. But is important to recognize why. First,

roughly 40-50 billion dollars of central bank intervention was required in the spring to prevent the dollar from falling below the Louvre rates. More recently, the dollar's strength can be attributed to market perceptions of an improving US trade picture and to a significant increase in US interest rates relative to those of other major economies.

The interest differential between long-term US and Japanese bonds increased from 200 basis points early in 1987 to 560 basis points in early June, although it has since fallen back to 475 basis points. The point being that it has taken higher domestic interest rates to attract foreign investors into US securities. This differential in part reflects a slightly tighter US monetary policy and in part concerns by foreign investors about the probability of a further dollar decline, and thus their demand for a higher risk premium to compensate. In any case, although higher interest rates may be a technique for financing the US current account deficit,they do not constitute a technique for reducing it (unless ,of course, interest rates rise so high as to generate a US recession). Over the medium-term it makes no sense for the US to want a rising exchange rate while it still has a large current account deficit.

There appear to be two general schools of thought on the course of the US current account deficit. The IMF, OECD, and European Economic Commission predict a modest decline in 1987 and 1988 -- to the $130-$140 range. A group of economists assembled by Brookings project a drop close to $100 billion, but a rise thereafter. My own forcast -- given the present set of exchange rates and domestic policies in the major economies -- is for a

current account deficit of roughly $130 billion in 1987 and $100 in 1988, with gradual further declines thereafter.

I therefore conclude that the dollar must fall a bit more in order to move the US closer to a sustainable current account position. According to our analysis at Goldman Sachs, taking into account the need for the US to further improve its trade and current account balances, and compensate for the fact that its inflation rate will exceed that of many of its largest trading partners this year and next, it is reasonable and appropriate to anticipate a gradual drop in the dollar to roughly 130 yen and 170 DM over the next twelve months and to 125 and 1.55 respectively over the next 24 months. This assumes that the US government avoids stringent measures to artificially prop it up; and such measures would, in my judgment be a serious mistake. It would likewise be a mistake to talk the dollar down below such levels, or to allow the dollar to overshoot.

It is important in this context to recognize that at some point in the future the dollar's decline, coupled with domestic policy changes in major economies, will have to be sufficient to cause the US to experience several years of trade surplus sufficient to cover interest payments on its external debt. Unless one assumes that the US can go on accumulating external debt forever, one must come to the above conclusion. The only debateable point is the pace of this process. And that largely depends on how much of a US current account other nations are willing to finance, and for how long. If the US maintains large interest rate differentials with other nations, private investors

may finance these deficits for a time, but will likely require higher and higher risk premia in the form of higher interest rates -- and that could seriously slow down the US economy. In this connection, it is inaccurate for other nations to believe that artificially propping up the dollar will help them avoid a slowdown in their exports to the US; slow American growth due to higher interest rates will do that just as surely as a weaker dollar, and probably with far more serious global implications.

The other technique for propping up the dollar and financing large US current account deficits, would be massive central bank intervention. But this tends to trigger inflationary pressures abroad. And it is doubtful that foreign central banks will be eternally enthusiastic about such a strategy.

Finally, of course, a continued large US trade and current account deficit would surely strengthen pressures in this country for new trade restrictions and subsidies, especially if Americans feel that necessary reductions in the dollar's value are being resisted by governments, including there own.

INTERNATIONAL ECONOMIC COOPERATION

It is important also to recognize that domestic policy changes must accompany currency changes. Investment rates in the US have been relatively low in this recovery compared to those of the past. This means that the additional exports which will be induced by the lower dollar coupled with stronger domestic demand for

those same products due to their becoming more cost competitive in this country could strain US capacity in some sectors. A lower budget deficit is needed to reduce interest rates and thus reduce the cost of borrowing to finance new investment to meet rising domestic and external requirements. It also reduces US dependence on imported capital and thus the buildup of US external debt.

Just as importantly, America's trading partners must recognize that the reduction of their trade balances with the US will create a drag on their growth. For the OECD trading partners of the US in 1984-1985 domestic demand grew at 2.8%, and increasing exports contributed .7% to their GNPs, for a growth rate of 3.5%. In 1986 domestic demand grew at 3.5% but trade deterioration subtracted 1.2% from their GNPs, leaving growth at 2.3%. In 1987 trade will continue to be a drag on their growth of roughly .7% of GNP, leaving a collective growth rate about the same as in 1986. Thus, they will need new stimulus to offset a weakening of their trade balances. Japan has indicated its plans to increase expenditures and cut taxes in an amount totalling $42 billion, Germany has not as yet decided whether it needs additional stimulus and if it does, how much will be required.

But there is serious danger that other nations may not have fully considered the impact on their economies of trade adjustments needed to improve international trade balances; collective miscalculations could lead to a reinforcing slowdown in world growth, especially when its adverse impact on the exports of already weak high-debt nations is factored in. The greater the

improvement in the US trade balance the greater the need for other major economies to take measures to offset the drag of deteriorating trade balances on their economies.

Quite apart from these issues of the moment are larger questions on which the West must focus. We are today in the midst of the second great transition of international economic power in this century. From 1920 to 1940 the US failed to recognize the economic strength it had inherited from Britain and the responsibility that conferred. It protected its markets rather than champion open trade, and waited to defend fellow democracies until it was almost too late. For 20 years the world lurched from one trade and financial crisis to another, then to political confrontation, and then to war. We need to conduct the present transition more smoothly.

The post-war order was predicated on the enormous economic and military power of the US. For 40 years, leadership of the free world required the US also to be its economic benefactor. Americans understood that growth abroad would be in their economic and security interest.

But a surge in the commercial and financial strength of America's economic partners, along with this nation's recent large trade deficits and new status as the world's largest debtor, have reduced its will and ability to shoulder global political, military and economic commitments.

Without a broadening of the role of other industrialized nations in reducing trade imbalances, strengthening world growth,

and helping to promote economic development, Western economies and alliances could be severely weakened.

If Americans believe that allies who have acquired financial strength are doing too little to help the US reduce its trade deficit and are not assuming a "fair share" of Western military, energy security and aid burdens, and if America's allies feel that the US is unfairly blaming them for problems of its own making, pushing them to adopt policies counter to their interests, and using its payments deficit as a pretext for backing off of commitments to the security of its allies or to open trade, Western economic and political relationships will suffer.

The race is between deepening economic problems and the collective leadership needed to resolve them.

The first requirement is for Europe, Japan, and the US together to reduce large trade imbalances in an orderly fashion without causing a global recession.

Finance ministers and central bank governors of the Group of Five have moved shared responsibility one step forward by engaging in a virtually unprecedented process of engineering changes in domestic policies and exchange rates. But sustained progress towards growth and balance also requires a change in attitudes toward future policy making in Europe, Japan and the US.

Europe and Japan will need to break out of the post-war complacency borne of the notion that the US would forever order its policies so as to ensure a healthy world economy while its trading partners -- perceiving themselves "less responsible" for that economy -- pursue policies aimed purely at domestic goals,

even if these are inconsistent with world trade and growth requirements. Western Europe and Japan depend heavily on a world economy the health of which now depends every bit as much of their actions as it does on those of the US.

Washington's attitudes too must change. President Reagan's failure at the Venice Summit to achieve his objectives can in part be attributed to the hard reality that a heavy debtor nation is in a relatively weak position to insist that others comply with its economic wishes. In today's international economy foreign support for US objectives must be merited rather than assumed or demanded. Erratic domestic policies, lecturing others when it cannot control its own budget, and blaming them for its home-made problems weaken Washington's influence.

Providing foreign assistance is part of the responsibility that accompanies wealth in Western nations. The US recognized this in the years after World War II, when it transferred 4% of its GNP abroad. The serious debt problems of much of Latin America and Africa cry out for greater attention. America's allies now have the capacity to provide more funds to nations important to Western interests while the US, in the process of cutting its budget deficit, is unlikely to appropriate significant new money in the immediate future. America's allies need to up their aid share and provide incentives for their private sectors to recycle, in the form of lending to worthy projects in the Third World, a larger portion of the capital they are accumulating. In so doing they would strengthen global growth and political stability; they would

also reduce pressures from Washington for "quick fix" stimulus in their own economies.

CONCLUSION

Midway through 1987 the world economy is in the midst of two major adjustments. From a major imbalance in world trade to a more manageable balance and from a world economy based on US hegemony to one based on shared responsibility. The two are directly related. Failure to reduce trade imbalances invites the type of frictions that weaken political and security relationships. Bad trading partners make bad allies. An increasingly indebted America will have an increasingly difficult time providing the strong leadership on which the rest of the free world relies. And accomplishing this task at the cost of sharply lower growth or recession would deal a severe setback to hopes for resolving the Third World debt problem and for avoiding protectionist measures in all economies. The US and its trading partners must forge a sense of collective responsibility for the world economy and wise policies to ensure its growth and stability now and in the future.

Senator SARBANES. Well, thank you.

Gentlemen, let me say, I think this has been an extraordinarily helpful panel. The statements and the testimony have been outstanding. We have also had a chance to go through the prepared statements, which will be included in full in the record, but I think that your comments have been very perceptive, and we thank you for the obvious work that has gone into this effort.

I want to develop a few points. Let me pick up on what Bob Hormats said at the end, the theme I have been sounding repeatedly, and that is that I think that other countries with strong economies are not carrying a responsibility in dealing with the world economy commensurate with the strength of their own economies. They need to do more. Obviously the United States needs to set its own house in order, but this reallocation of responsibilities, particularly given the strategic burden which we carry in relationship to other countries, has to be recognized and appropriate adjustments have to be made.

What I would like to do now is this, I would like to take Mr. Hilty's prepared statement—does each of you have a copy of it there in front of you?

Mr. HORMATS. Yes.

Senator SARBANES. Let's go through that for a second, because I want to address, first of all, Fred Bergsten's point that anything we seek to do in the trade area is perceived as protectionism. That is an overstatement, but when we talk about measures that can be taken to address our situation, no distinction is made between going too far and therefore falling into protectionism, and trying to do something about fairer trading relationships.

Now it may be, as Secretary Baldrige said, that if we eliminated all unfair trade practices with the Japanese, it would only mean $12 billion to $15 billion on the trade deficit.

I happen to think that is consequential, not inconsequential, particularly when Secretary Baldrige is suggesting that in order to address the trade deficit, we must do someting about the budget deficit, and then suggests that if we eliminate EDA, we will save $200 million; $200 million there; yet we are talking over here, by his own admission, $12 billion to $15 billion, if we address these unfair trade practices.

So it is not inconsequential. Second, we can't maintain any stable order if the rules are not perceived as being fair. We can hardly tell people that they ought to be competing if they think they are doing it under unfair terms.

Mr. Hilty, in your prepared statement, you have an interesting point that more than half of Japanese auto production goes abroad. Let me ask, among auto producers, is that unusual?

Mr. HILTY. Yes, it is.

Senator SARBANES. I guess now the Koreans are doing the same thing, because they are following the Japanese strategy, probably. But amongst other auto producers, is their major market domestic?

Mr. HILTY. Yes, there has been a rule of thumb that over half of one's production should be in your own country. This is true for Germany and England and France and Italy. This has been a rule that has been part of the bible for the auto industry in the past.

So, yes, Japan broke that rule. They tried to develop their export industry as part of their strategic development; and as you mentioned Korea, Taiwan, and Malaysia are starting to emulate that precedent.

Senator SARBANES. Now, you say, "Available data suggests the Japanese auto industry in recent years was profitable only in the United States and Canada."

To what extent can you sustain that point?

Mr. HILTY. Almost all the auto financial analysts make this statement. We have looked at annual reports and then tried to determine where their profits come from. Yes. I would say this is a generally accepted pattern and the Japanese also say this. I can give you or your staff quotes.

Senator SARBANES. All right. Now do the other panelists contest that, as a factual matter?

Mr. HORMATS. No. Most Wall Street analysts that have looked at it agree with that very point.

Senator SARBANES. They agree with that?

Mr. HORMATS. Yes, sir.

Senator SARBANES. All right. So that is a fact. Now why is that an acceptable approach toward international trade? I mean, as we look at this situation. The World Auto Market, which shows that—let's see, 24 out of 33 million. So that is 75 percent of passenger cars is North America and Western Europe. And North America is, what about 35 to 40 percent, I guess; right?

Mr. HILTY. Right. If you add it all together, two-thirds of the current car and truck market is in Western Europe and North America.

Mr. BERGSTEN. Mr. Chairman, if I might make a comment on that, I think you want to ask, perhaps, why it is that the Japanese auto sales in the United States and Canada were profitable the last few years, when they were not profitable elsewhere. And I don't have the whole answer to that, but I will give you two parts of the answer.

Senator SARBANES. OK.

Mr. BERGSTEN. One is the exchange rate. When they were able to convert a strong dollar back into so many yen, they were able to get a tremendous advantage vis-a-vis their earlier pattern here, because that strong dollar bought so many yen. And that was one reason.

A second reason was our own import restraints on their auto exports to us. I think it is well known that by limiting their access to our market in volume terms, we promoted price raising by the Japanese exporters—which you do whenever you set up a quantitative restriction—and we encouraged them to upscale the models that they sold into the U.S. market. And again, it is known that the higher up the scale of models you go, the higher is the profit per unit.

So what I wanted to say, Mr. Chairman, is put the two things together—I am not suggesting this is the totality of the picture—and Don Hilty knows this better than anybody, and he will be able to explain more. But our policies which promoted such a strong rise in the value of the dollar and limited their access to our market in volume terms enabled them to charge much higher

dollar prices which, when converted back into yen, gave them an enormous rise in their total profit position.

Now I don't know if that is the totality, but I would suggest that was a big part of the picture.

Our industrial policy, in some sense, was to promote, enormously, the profits of Japanese auto companies, and I don't think it was very smart.

Senator SARBANES. Well, Mr. Hilty, do you want to respond to that?

Mr. HILTY. Thank you for the chance. I disagree completely with that analysis.

Senator SARBANES. Good! Let's keep this thing moving. [Laughter.]

Mr. HILTY. Right. Thank you. I agree with part of it, that, yes, the strong dollar helped them generate——

Senator SARBANES. Let me interject right there, if I could, to all of the panel.

I want to put a general question to each of you. Would any of you, if given the choice, prefer to be weak rather than strong? [Laughter.]

Mr. JASINOWSKI. No, Mr. Chairman.

Senator SARBANES. I can say you are a strong person, or am I going to say you are a weak person. Now is there anyone there who would want to be termed a weak person?

Mr. JASINOWSKI. No, Mr. Chairman.

Mr. BERGSTEN. Not this group. [Laughter.]

Senator SARBANES. Now let's take the "strong dollar" and the "weak dollar." In fact, the so-called "strong dollar," was not a good dollar, from our point of view, was it? It is better for us to have what is now referred to as the "weak dollar" that to have what we used to have as the "strong dollar"; right?

Mr. BERGSTEN. I wouldn't call it a weak dollar. I would call it a competitive dollar. If the dollar was undervalued by 20 percent like we had in the late 1970's, that is bad too, because that is generating excessive inflationary pressure.

Senator SARBANES. All I want to do is stop using the terms "strong dollar" and "weak dollar," because they carry with it a connotation of desirability and undesirability, which is not related to what an analysis may lead you to conclude. That is all. And you all agree with that I guess?

Mr. HILTY. Yes.

Mr. JASINOWSKI. Yes.

Senator SARBANES. Please go on.

Mr. HILTY. Right. That portion of the profits is true, that they did convert those dollars into a lot of yen. However, I don't think that they gouged the American public during the quota period. There have been quite a few studies on this subject. The IMF has recently analyzed the situation and conclude gouging. I think it is embarrassing to the economics profession that they did this. Before quotas, the auto companies were pricing about three-fourths the rate of the CPI. If there was price gouging going on during quotas, you would think that relationship would increase, that the portion of the CPI that was charged for cars would go up. It went down during that period. I think the fact that quotas were year by year

by year, put pressure on the domestic companies. I know it did in our case. We did not want to gouge, because if we got greedy, those VRA's would go off immediately. And I think the Japanese also did not gouge, because they were already making a lot of profits.

I just wanted to make that point.

I think you mentioned the point too that the rest of the world knows we have a trade problem, and I think foreign exporters to the United States have been waiting for the shoe to drop for a time when they would get their hands spanked—but that hasn't happened.

I am not too sure that if we have some measures—I wouldn't call them protectionist—but have measures to try to restrict their unlimited access to the United States, that they would retaliate. The Japanese are not retaliating against Western Europe, and they severely restrict Japanese car exports into Western Europe.

I think they realize that they are taking a lot of advantage of our markets.

Senator SARBANES. Mr. Hormats, I know you have to catch a plane. We appreciate your testimony very much.

Mr. HORMATS. Sorry I have to leave.

Senator SARBANES. Thanks for the statement. It is very helpful.

Mr. HILTY. I think that many foreign exporters to the United States have known they have had a good deal, and they are expecting us to slow down this unlimited access to our markets, and I don't think that we would face a lot of protectionist measures on their part.

Senator SARBANES. Depending on how far we went and what we did?

Mr. HILTY. That is correct. I am amused at the current references to Smoot-Hawley. When the United States implemented Smoot-Hawley, we had a trade surplus. We got exceedingly greedy. We now have a trade deficit. It is an entirely different situation.

Mr. JASINOWSKI. Mr. Chairman, I would like to take a little different tack on the question you raised, to emphasize, notwithstanding the high quality of much of the Japanese products, the extent to which their actions simply reflect a mercantilistic development strategy, which is a major part of what the Japanese have been, I think, justifiably, from their own point of view, pushing for sometime now. It is an export-oriented economy. They built the whole strategy up on that notion. Minimal domestic consumption. Maximize exports. Ship them out as fast as you could, whether or not it was autos or anything else, and that is how you grow!

And I don't think it is much of an exaggeration, if any, to say that was the Japanese strategy. And I think that part of that was barriers to American products, and in some cases, it was even some industrial policies which subsidized their exports.

So it is quite appropriate for the Congress and the administration to require the Japanese to open their markets, be more fair in trade and accept greater responsibilities, as Bob Hormats said, in terms of the world economy and national defense.

I think the problem in the trade bill, is that there are a number of ways to do that, and there are a number of ways to do it outside of the trade bill. As you get into the Gephardt amendment, however, it was flawed substantially by supporting the idea that you

would automatically use surpluses, period, as a test for the determination of trade policy and trade policy actions. And I think that as long as there was this automatic focusing on surpluses which could be, for a variety of causes, it was not really acceptable trade theory and not acceptable, politically.

Senator SARBANES. Well, I would have to take another look at the Gephardt amendment, but I thought he linked surpluses to unfair trade practices.

Mr. JASINOWSKI. The original Gephardt amendment did not. Now there have been subsequent proposals put forth that have attempted to do that, and that may be considered in the Senate in some form, and I think that as you begin to make that connection, you obviously have a different kind of judgment. But you did ask about Gephardt, and the original Gephardt amendment did not link it to unfair trade practices.

Senator SARBANES. Now, if it is linked to unfair trade practices——

Mr. JASINOWSKI. Yes, Mr. Chairman.

Senator SARBANES [continuing]. Would that put it in a different light, in terms of your analysis?

Mr. JASINOWSKI. In my opinion, it puts it in a different category, and one has to, then, look at the specific amendment and decide what it means, although I think that once you get into areas of looking at aggregate surpluses, and you trigger specific trade policy action, you are in a very crude policy area. I am all for sending strong signals to the Japanese. I suggest to the Congress we simply put it in the findings of the bill or we pass it in a resolution, but when we start to trigger 301, 201 or anything because of aggregate surpluses, we are in an area where the Government is not very likely to be able to be successful.

Senator SARBANES. Yes, Congressman Scheuer.

Representative SCHEUER. Mr. Jasinowski, let me say, this has been a spectacularly wonderful, terrific, enriching hearing, and I am grateful to you all.

You know, this is an imperfect world, and we have imperfect ways of catching the attention of some of our foreign trade partners. You use words like "obdurate" and "obstinate" describing the Germans, who have been warm, cuddly puppies compared to the Japanese. Somebody else here said, we are going to measure progress with the Japanese, not by inches but by millimeters. And I think, if there was a smaller measure of linear distance than millimeters, we could take that, because they can erect this whole morass of formal and informal impediments to trade. They can erect that whole thicket faster than we can tear them down by means of these agonizing negotiations, product by product, that take several years each one. And by that time, you know, there's been a whole growth of another thicket.

The other thing, as soon as you penetrate the thicket, the minister resigns, and you have to start all over again with a new minister.

I really sympathize with our trade negotiators.

Now this was a very crude attention getter, and we are simply saying to them, this Congressman from the Eighth District in New York—that's Scheuer—when he had small kids, he used to beat the

hell out of them three or four times a week, on the principle that if he didn't know what they were doing wrong, they knew what they were doing wrong. [Laughter.]

Now this is our message to the Japanese. We can't cope with this thicket, but on the bottom line, we cannot accept the result. And what we want you to do is work your way down from a $60 billion surplus of $5 billion or $10 billion surplus, $12 billion, who cares, but a manageable, reasonable surplus. And we would hope that you would tear down those thickets you own way. You know the problem. You know your own distribution system. You know how to stop requiring us to take apart and put together every car that comes into your country. We don't do things like that. But you do. You solve that problem. We are just telling you the result that we want to achieve.

Now that, admittedly, is a very crude way of approaching the Japanese, but if you use words like "obdurate" and "obstinate" for the Germans for their moderate degree of noncooperation, what kind of language would you use to describe the Japanese attitude?

Mr. JASINOWSKI. Well, first of all, Congressman——

Representative SCHEUER. And how do we approach that problem?

Mr. JASINOWSKI. First of all, Congressman, I agree with you, personally, that as a crude attention getter, that the Gephardt amendment in the House was a positive step forward and always though that raising this issue, in that sense, was positive. We are now getting down to the final issue of what we put in the law, and I think that the debate is always refined in that process, and I think one has to think twice, after one's gotten people's attention, and you are making a decision about the law.

I don't know the answer to what you put in the law, but I do know enough about trade policy and negotiations to know that you want to be cautious about linking bilateral surpluses with very specific trade policy actions, because we are not going to do it well.

As far as what we do next, that will be debated on the Senate floor, and you gentlemen will decide, and then it will turn to the conference. So I think that what you did in the House and what you are suggesting as a crude attention getter, personally, was a very important step forward and actually improve the situation.

Representative SCHEUER. Just one little followup question. You mentioned, I believe, that 60 to 75 percent of the route toward real competitiveness in the private sector has yet to be traveled. They may have traversed the first 25 or 30 percent. They have two-thirds of the job ahead of them.

What is going on? I mean, it is a wonderful privilege for me to be asking a leader in the corporate sector, and I have just one question after this for Mr. Hilty, and then we will all go and have lunch.

What is going on in the private sector, and what kind of initiatives is the NAM exercising to concentrate some minds in our private sector?

Mr. JASINOWSKI. Well, I am glad you asked that, because we have just completed a survey, and I will send you more of the details, but the summation of the survey is that most major manufacturing and medium-sized manufacturing corporations have gone through the worst of the cost-cutting associated with being more

competitive or the best of the cost cutting, depending upon how you want to look at it. They are now focusing first on quality and service and that is what people are spending more time on than any other thing in corporate America today.

Second, as a priority, they are focusing in improving the manufacturing process through advanced manufacturing techniques and the whold range of things associated with what you do inside a plant to make products better.

Third, they are looking at a whole range of ways in which human resources are better utilized, all the way from incentives and bonuses to changing the structure or hierarchies to making the dynamics of culture and the commitment to competitiveness different. And I think that is a very important area and it varies a lot from corporation to corporation.

The final way is an enormous amount of attention going into technology and how you commercialize products more rapidly out of universities, out the Federal labs, out of corporations into new products and processes in shortening the product life cycle.

So those are four of the major priorities. Quality dominates virtually everything else at this point in the corporate world in most corporations, and they are at the point where they are moving forward very aggressively but still have quite a lot of work to do.

Representative SCHEUER. We would appreciate it if you would send that.

Mr. JASINOWSKI. All right. We will send you some material, and I would be delighted to come and spend some time with you, as well, Congressmen.

Representative SCHEUER. A question for Mr. Hilty. Do you know of any car manufacturer in this country that has ever designed a car for export to Japan that had a right-hand drive?

Mr. HILTY. No.

Representative SCHEUER. Let me tell you. I get to Japan from time to time. I speak the language and I enjoy it, and I get there on private trips and congressional trips. And from time to time, the American Embassy has pity on me, and they send an Embassy car to pick me up and take me to meetings, an official meeting of one kind or other. And you know, I feel I am sitting in the death seat. When I sit on the left-hand side of the back seat, I am in a state of absolute, unadulterated panic.

Now the fact that no car company has ever designed a car for export to Japan with a right-hand drive, doesn't that fact tell you something about attitude and behavior of American corporations in their utter failure to think about the market, to think about preferences, to think about the most elemental considerations of safety and mental well-being of a person who sits in the back of that car? Doesn't that speak volumes about the failure of marketing, about the failure to acquire Japanese-speaking Americans? I think the Japanese have 50,000 English-speaking American salesmen here. We have less than 1,000 over there.

From the point of view of marketing and concern about preferences, styles, quality, custom and what not, isn't there a vast distance for the corporation to travel in that area?

Mr. HILTY. Yes. This is a complicated subject. I will make it as simple as I can—and you asked a lot of questions too.

It is a small market. It is only a 3-million-car market, so we would not even have a potential of selling large volume there. So small cars are probably not worth trying to change for that market.

Representative SCHEUER. What would the potential market be for right-hand drive cars in many other countries, England, Bermuda? I can't even mention them all.

Mr. HILTY. We do make them for those markets. There is a status symbol, too, for the Japanese to be driving a U.S. made vehicle. When you are driving a right-hand vehicle, you know——

Representative SCHEUER. A left-hand drive vehicle?

Mr. HILTY. It is a status symbol to drive a left-hand drive car; it is different. And the BMW's——

Representative SCHEUER. They are willing to go into cardiac arrest every time they turn a corner?

Mr. HILTY. I know. I lived in England and drove to the Continent, and it is not fun to sit in that seat; that is correct, especially when you are behind a big truck. How do you pass?

As you mentioned earlier, too, it helps their industrial espionage to send a vehicle over there, because they take it apart. You have to give the chemical composition of all the components. So it is not worthwhile because the volume potential is not great in such a small market. We are selling big cars to Japan now, more now that the currency alignment has changed in the last year or so. But the volume is so small.

Representative SCHEUER. Have you ever tried to estimate what the volume would be if you gave them a car with a right-hand drive? Wouldn't that automatically give you a quantum job in your volume possibilities?

Mr. HILTY. We do make right-hand drive cars in this country, but the Japanese don't always ask for them. They ask for left-hand drive. I will assemble more details on this subject and give you an answer.

Representative SCHEUER. I would appreciate that.

Mr. Chairman, let me say, it is after 1 o'clock, and my heart goes out to all of you. You have been very patient and very forebearing. It has been an absolutely fascinating hearing, and I have truly enjoyed it. And I thank you for it.

Senator SARBANES. I think it is only the fact that Congressman Scheuer has a vote and I have a vote that is going to bring this to a close.

Let me just ask two quick questions. One is, is there not a problem, and it goes to the mercantilist approach, with countries that decide to target the American market, and then that is their objective. And so, you know, like the Japanese now, less than half of what they do on autos is used at home. I mean, you could have some small principality, whose state of development was fairly low—this is not Japan, obviously, decide they were going to go into the—they were going to build a steelmill and export their steel to the United States, and that was going to be part of their economic development program.

Isn't there something wrong with the international system, if it works that way?

Mr. JASINOWSKI. There is a problem with respect to how the particular country makes a transition out of that and what effect it has on the international economy, and I think either Fred Bergsten or Bob Hormats alluded to the fact that if they don't stimulate their economies, they are not going to have enough growth to offset the decline in exports.

I think top the Japanese credit, there is quite a lot of thinking and some actions in that country to move toward a building up of their intrastructure and dealing with a lot of domestic priorities that they have neglected or not done as much on as they could, and therefore, if these countries move to stimulate some of their domestic economic growth, it is quite possible that we could avoid the most adverse effects of trying to make up for the lost export growth.

Mr. BERGSTEN. Mr. Chairman, it may be unique in the auto industry, as Don Hilty said, for a country to export more than half its output, but it is not unusual at all, in trade patterns more broadly. Ask the American soybean industry, ask the American aircraft industry, ask many industries in many countries, where exporting more than 50 percent of output is common, not unique. So just because somebody exports more than half its output, I would not immediately condemn him.

Now I am with you, if there is a concentrated, targeted strategy that includes unfair trade practices, and the like, sure, they have a problem, but just that statistical relationship, at least viewed across industries, including agriculture, is by no means an unusual phenomenon, even in this country, with our huge market and relatively small share of the total economy that goes into export.

So I wouldn't look at that per se.

Let me mention one other point. I yield to no one, I think, during my experience in government, as having tried to at least be a tough negotiator, and I can give you a long list of bruised foreign counterparts, so I wouldn't, I think, be guilty of the charge of being soft on negotiating partners.

The issue is what you hit them over the head to get.

Now the Japanese weren't benignly happy to watch the yen rise from 260 to 140 against the dollar. All the Japanese could now talk about is deindustrialization of their country, hollowing out of their corporations, et cetera, et cetera. Now is is a lot of crocodile tears.

Senator SARBANES. But we never should have allowed it to happen in the first place.

Mr. BERGSTEN. Absolutely right.

Senator SARBANES. Now they make an argument that somehow they are not being dealt with properly, when it shouldn't have happened in the first place.

Mr. BERGSTEN. Of course. Of course, but——

Senator SARBANES. And if the point had been made then, they would have had no complaint, because it would have been easily recognizable at the time.

Mr. BERGSTEN. And you said that at the time, and I said that at the time, but the U.S. Government——

Senator SARBANES. That is why we are going to require the report that we have in the trade bill.

Mr. BERGSTEN. That's right. Exactly. The U.S. Government was cheering on the high dollar, as you well know. And so my only point is, it then had to be turned around. The U.S. Government had to beat on the Japanese in that area. That is where the big money is. Mr. Hilty's chart, I think, very nicely points out, yen at 120, he caps his deficit. Well, that is one way to do it. Among his options, I regard that as a healthy sustainable way to do it, compared with some of the others.

It is not that you don't be tough. The question is (a) what works and (b) what is healthy in an overall economic sense.

Senator SARBANES. Now let me ask one—I have to go vote—one final question.

Is there anyone on the panel who thinks that it is possible to be the world's great power and at the same time be the world's largest debtor, that those two things can be squared with one another?

Mr. BERGSTEN. Since I have the microphone and since we are doing a big study on that at my institute, I will simply say, history knows of no possible example of that type. Indeed, the historical correlations run in precisely the opposite direction.

Mr. JASINOWSKI. I would agree with that, Mr. Chairman, and just put it on a commonsense basis. I think that you use debt to invest in order to build for tomorrow, and that is always a temporary thing, and in this case, we are not even using the debt, in many cases, to invest.

Mr. HILTY. I agree that historically this has never been done and probably never will be done.

Senator SARBANES. Gentlemen, we thank you very much.

[Whereupon, at 1:15 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, July 2, 1987.]

STATE OF THE ECONOMY AT MIDYEAR

THURSDAY, JULY 2, 1987

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes and Melcher and Representative McMillan.

Also present: Richard F Kaufman, general counsel; William Buechner, Dan Bond, Jim Klumpner, Paul Manchester, Dale Jahr, and Chris Frenze, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. We will now go to our panel as the committee turns its attention to a series of hearings that we have been holding this week on the midyear outlook for the economy. We have with us two distinguished witnesses, Mr. Lawrence Chimerine, who is the chief economist at Wharton Econometrics; and Mr. Alan Blinder, who is professor of economics at Princeton University.

Gentlemen, we have your prepared statements. If you could maybe take 10 minutes or so each to summarize your views, we would be happy to hear from you.

Mr. Chimerine, have you worked out an order between yourselves?

Mr. CHIMERINE. I'll go third. Whatever you like, Mr. Chairman.

Senator SARBANES. Well, since all things come full cycle, if you go third that means you will go first. So why don't we hear from you and then we will hear from Professor Blinder.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN, CHIEF EXECUTIVE OFFICER, AND CHIEF ECONOMIST, WHARTON ECONOMETRICS

Mr. CHIMERINE. Thank you, Mr. Chairman. I'm delighted to be back and to see you again. I have submitted a fairly lengthy prepared statement which I hope you received. I think you may have received it a little bit late and I apologize for that. I'll blame Gramm-Rudman for postal cutbacks.

As you requested, I will try to briefly summarize my prepared statement. In doing so, I will focus on the two or three subjects that you asked me to.

First, the current economic situation as I see it; second, the near-term outlook particularly for the rest of this year and perhaps 1988; and third, and in the process, to discuss some of the major factors that are affecting the economy and impacting economic performance; and then finally, some thoughts on budgets and fiscal policy.

Let me start with the current situation. I think the committee is well aware of the fact that about 3 years ago, in the early summer months of 1984, the economy seemed to move into a pattern of relatively slow and erratic growth that has continued ever since that time. Over that 3-year period, economic growth has averaged about 2.5 percent, which is considerably below what it had been earlier in the postwar period, even though in my view we have nowhere near completed the recovery process.

In my judgment, this pattern of relatively slow overall economic growth in the United States is still continuing. The most recent evidence is quite mixed—some of the indicators show a little bit more strength, while others have softened.

But when you add it up, you can really draw two conclusions. First, on an overall basis, the economy is still growing, but fairly slowly. There is no evidence that we are sliding into recession. By the same token, the pickup in economic growth that's been projected for the last several years hasn't happened, and is still not happening.

And second, one of the reasons why the economic indicators are mixed is that the mix of economic performance across major sectors is changing. In particular, trade is finally starting to improve, especially in real terms. That is, the trade deficit. But at the same time, domestic demand has softened very substantially from the rates of growth we had in the last several years, especially consumer spending and construction. The shifting mix between domestic demand and foreign trade is what accounts for the uneven performance among the economic indicators.

Again, when you add it all up, I believe the underlying growth rate in the economy right now is still roughly in the 2 percent range. In my judgment, that is unsatisfactory, and as I'll get to in a moment, I continue to believe that not only will this kind of slow growth continue but that most of the risks are on the downside.

My concerns really reflect that no matter whether you look at the secular factors that are affecting economic growth now in the United States, whether you look at economic policy, or whether you look at cyclical forces, all of them suggest to me that the best we can get is a continuation of relatively slow economic growth for the immediate future, and it may be far more than the immediate future. In effect, this slow growth of 2 percent or so might persist for many, many years and, second, as I said a moment ago, the risks are on the downside.

Let me take you through each of the three kinds of categories of factors very briefly.

First, I think the economy is largely being affected right now by some major secular developments, or secular forces, which are holding down economic growth. The two most significant, in my view, are, first, the deterioration of the relative competitive position of the U.S. economy in world markets, and second, the recent

debt buildup. We've talked about this at previous sessions of this committee.

In my judgment, there has been a significant deterioration in U.S. competitiveness, primarily being reflected in a dramatic narrowing of the advantages in productivity, technology, and product quality that the United States had over most of the rest of the world back in the 1950's and 1960's. Our traditional competitors have narrowed the productivity gap—in some cases, they have eliminated it completely. And in many industries, they have gone ahead of the United States. At the same time, a whole raft of new highly efficient competitors have emerged on the scene in many industries, many of them located in the Pacific Basin, in Brazil, or in other parts of the world.

And 20 or 25 years ago, when we dominated the world economy, when we had relatively large trade surpluses, when we had large market shares in almost all manufacturing industries on a global basis, our productivity was far ahead of the rest of the world. And, in fact there was a very limited number of competitors in those days.

What's happened over the last 10 or 15 years has been a sharp narrowing of those productivity advantages. What has made it most dramatic, and what hurts us from a competitive standpoint is that, in my judgment, we can no longer afford the differences in labor costs and capital costs which we used to be able to afford or justify by the large advantages in productivity and product quality that we had 20 or 25 years ago.

We can spend hours arguing why our advantages have diminished, whether it's because we got complacent, or because the rest of the world has caught up to us, or because of the faster transfer of technology, or because of the actions of multinational companies overseas, and so forth. But I think that what's most important for current economic performance is to understand that there has been a significant change in relative competitiveness.

In my judgment, this is limiting economic growth. In recent years it limited economic growth by these large and growing trade deficits. What's happening now essentially is that the ramifications of the change in U.S. competitiveness are changing. It's affecting the economy differently, but still limiting economic growth on an overall basis, primarily because those large trade deficits and the resulting large explosion in U.S. foreign debt are unsustainable.

The adjustments which are not taking place to reduce those trade deficits are having negative side effects elsewhere on the economy, especially on domestic demand. In particular, a weaker and weaker dollar is not a cost-free solution to large U.S. trade deficits. It is adding to inflation, and, as a result, squeezing purchasing power for many consumers, and pushing up interest rates at a time when interest rates are already too high given how sluggish the economy has been. The same is true for wage restraint in the United States. More and more companies are holding down wages, either freezing them or slowing the rate of increase, which does help them to become more competitive, but of course holds down purchasing power. And, a large number of companies, particularly some of the well known, most visible companies, have continued to lay off large numbers of relatively high-wage employees.

Again, this lowers their average costs and makes them more competitive in world markets, but at the expense of holding down purchasing power in the United States.

We have thus now entered into a period, in my judgment, where real wages are stagnating. This is the principal factor in limiting consumer spending. So the ramifications of our changing competitive posture in world markets are shifting from large trade deficits to weaker consumer spending, and really, to weaker domestic demand in general, but still as a result, limiting overall economic growth.

Second, I believe we are beginning to now pay a price for the literal explosion of private debt in ths country in recent years. We've had a fun party, financing a large amount of expenditures and financial activity by going deeper and deeper into debt, but now the rising debt burdens of recent years have begun to limit consumer spending, on top of the squeeze on purchasing power. In addition, we have a large number of corporate clients who are telling us that they are holding down their capital spending because of the already difficult time they are having servicing the debt they have accumulated in recent years. So domestic demand, in my judgment, is also now being limited by the buildup of debt in recent years.

We have essentially borrowed from the future and the future is not—as a result, this factor is contributing to slower growth as well.

I think the same is true when you analyze economic performance from a policy standpoint. We are now really paying the price for large budget deficits in recent years. They are keeping interest rates too high at a time when, 3 or 4 years into the recovery, a lot of previous pent-up demand has been used up, there has been a lot of overbuilding in the economy, and excess capacity is widespread. We thus need lower interest rates to stimulate the economy, and large budget deficits prevent that from happening, in my judgment.

The increasing reliance on foreign capital only aggravates the problem. And now we are entering into a period of reduced fiscal stimulus, which may be producing the worst of both worlds, at least in the short term. Tax increases and spending cuts are producing a modestly restrictive fiscal policy, while at the same time the deficits are still high enough to prevent more downward movement in interest rates. Monetary policy is thus becoming less useful. The Fed feels constrained by concern about the need to make sure foreigners continue to be willing to hold dollar assets, and by large budget deficits, so they have much less leeway to ease than they did 15 or 20 years ago despite the slow growth environment, so monetary policy is not a major source of stimulus either.

And finally, when I look at cyclical factors, I reach the same conclusion regarding growth. There is a now a big overhang of auto inventories which is going to be worked off through lower production in the months ahead. In other industries, inventory policies remain very, very cautious.

Economic growth outside the United States is quite sluggish, so that even with a weaker dollar, the improvement in our exports will be very slow and gradual. More and more State and local governments are experiencing a budget squeeze and, as a result, are being forced to cut their expenditures.

And I mentioned earlier that a lot of previous pent-up demands have been used up. So there is really no cyclical thrust to the economy.

When you put all this together, I think the best expectation for the second half of this year and for 1988 is that growth of around 2 percent is likely to continue, with some modest and gradual improvement in the trade dificit, and with very little growth in domestic demand.

I think the risks are on the downside. First, if the dollar does go through another sharp decline, interest rates will probably rise again. The impact of monetary policy is now essentially assymetrical—if interest rates shoot up, I think we will be in a recession very quickly. But modest declines in interest rates sort of push on a string, without generating much more spending, but if interest rates do start to move up I think it would significantly hinder the economy.

Second, we can't rule out a worldwide recession in view of the cautious policies in the rest of the world. Competitive cost cutting now seems to be the No. 1 priority almost everywhere. The Japanese are restraining their wages in order to offset the effect of the strong yen on their competitiveness. The Germans are starting to do the same. There's a real risk of a worldwide recession.

Third, when you have the saving rate at an all-time low, household indebtedness at an all-time high, and real incomes barely growing, you certainly cannot rule out a major retrenchment by consumers, particularly with confidence showing some signs of eroding.

These are the major downward risks which could easily convert what I believe will be 2 percent average growth into even weaker growth, or no growth at all.

One or two last comments, Mr. Chairman. First on inflation. There was a scare several months ago when gold prices shot up, other commodity prices were rising, long-term interest rates increased quite dramatically, and some of the major price indexes increased quite rapidly. Many people began to wonder whether or not some of these predictions we've heard in recent years that we're poised for 6 or 7 or 8 percent inflation were beginning to come true.

I don't think that's the case at all. Clearly, inflation is currently higher, and will remain higher, than it was a year or two ago, primarily because we had a number of temporary forces holding down inflation during that period, especially weaker food and energy prices, and a strong dollar.

Those are now being reversed. Some increase in inflation therefore was to be expected. It's in fact almost necessary if we're going to reduce the trade deficit.

What's most important, though, is that the conditions which could trigger a wage-price spiral, and a major acceleration of inflation, beyond the 4 or 5 percent range that will take place as a result of the factors I just mentioned just don't exist. There is still widespread excess capacity, oversupplies of most commodities, and wage restraint is still the order of the day. Many of the automatic cost-of-living adjustments in union contracts have been scaled back or weakened considerably in recent years. More and more compa-

nies are increasingly competing against low wages in the Far East, so wage restraint is still necessary on their part. And most companies want to rebuild low profit margins first before they even consider accelerating their wage programs. And, of course, economic growth is quite sluggish throughout the world.

Under these conditions, I don't see any major risk of a wage-price spiral, or of a dramatic pickup in inflation, and I would suggest that any policies that are geared toward holding down economic growth even further as a result of concern about inflation would be misguided in the current situation.

The last issue I'd like to discuss is the Federal deficit. I am extremely concerned, Mr. Chairman, that the Federal deficit in fiscal 1988 is going to be higher than that in fiscal 1987. This year's deficit is being held down in part by a one-time bulge in revenues as a result of the tax law change, particularly with respect to capital gains. Some of those revenues are very likely being borrowed from next year. On top of that, the increase in inflation, which is mostly in oil prices and import prices, is going to push up the cost of indexed programs, while the tax base is not being increased by it.

Third, I think some of the costs of other programs are being understated, and, finally, economic growth is probably being overstated.

There is thus a very strong chance that the deficit could rise to at least $180 billion next year, or even higher, even if we continue to get roughly 2 percent economic growth.

I would strongly urge that additional declines in the Federal deficit are necessary, while at the same time, our priorities are altered. I think we have to review the entitlement programs and convert as many of them as we can to means tested programs. We also have to look carefully at defense for additional savings. I think we are also going to need some modest tax increases because, in my judgment, we are underspending in those areas that are critical for future competitiveness and productivity improvement, such as education, job training, and so forth.

In effect, I think it's about time we recognize that we not only have to put Federal deficits on a continued modest downward trend, but that simultaneously we have to change some of our priorities, and that some additional revenues will be necessary. And the longer we put off the problem, the worse it's going to become.

It must be particularly frustrating for the Congress because each year you make cuts in some social programs, or in defense, and the rise in interest expense just eats that up and you're back in the same situation. So I think the deficit situation must be addressed, but I think it has to be done simultaneously with a reevaluation of our priorities, our needs, with particular focus on what we have to do to restore productivity growth and improve our competitiveness on a long-term basis in this country.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, and I am the Chairman, Chief Executive Officer and Chief Economist of Wharton Econometrics. I am delighted to have this opportunity to testify before the Joint Economic Committee on the current state of the economy, the economic outlook, and fiscal policy issues.

SUMMARY

In sum, my views are as follows:

1. Economic growth in the 2% to 2.5% range is likely to continue for the remainder of this year, 1988, and beyond. This reflects a number of secular factors, as well as relatively restrictive policies, which are holding down economic growth on a relatively long-term basis in comparison with earlier years.

2. The risks are predominantly on the downside, especially for the very near term. Thus, complete stagnation or even a recession cannot be ruled out during the next eighteen months.

3. While inflation is accelerating in comparison with the last several years, a major wage-price spiral is not likely. Thus, I expect the inflation rate to average between 4.% to 4.5% over the next several years.

4. The outlook for the federal deficit remains poor -- in fact, the deficit in FY 1988 is likely to exceed that of FY 1987 unless the current deadlock in Washington is broken.

5. I continue to believe that it is essential that future deficits be reduced on a gradual basis. However, it is equally important to increase funding for those programs which will positively affect productivity and competitiveness. In my view, in order to both reduce deficits, as well as increase funding in some critical areas, some modest tax increases are essential.

THE CURRENT ECONOMIC SITUATION

Despite the relatively large increase in real GNP in the first quarter, and despite some shifts among major sectors and industries, the pattern of relatively slow and erratic economic growth which began in the early summer months of 1984 still remains in place, as indicated by the following:

1. Most of the rise in first-quarter GNP was in inventory investment, especially for autos and trucks. Recent cutbacks in motor vehicle production clearly demonstrate that the buildup was involuntary, and is in the process of being reversed. In addition, first-quarter GNP benefited from an unsustainable decline in oil imports.

2. While industrial production rose by a relatively large 0.5% in May, industrial output actually fell slightly in March and April (even with upward revisions). Furthermore, while cutbacks in motor vehicle production referred to earlier were a significant factor in relatively sluggish industrial production in recent months, the sluggish pattern is relatively broad-based.

3. Although the unemployment rate dropped sharply in April, and stayed down in May, a large fraction of the increase in new jobs continues to be in low-paying services. Furthermore, the rate of increase in the number of new jobs has slackened from earlier in the recovery.

4. The slower growth in consumer spending that began last fall has continued in recent months, especially for purchases of goods. Nonauto retail sales have essentially been stagnant in recent months, especially for appliances and other household durables. Moreover, reports from many retailers indicate activity thus far in June has not improved significantly. Sales of autos have remained weak even though the payback from previous incentive programs, and from tax-reform spurred purchases late last year, appears to have already been completed.

5. Housing starts have declined in the last two months from the near 1.8 million rate earlier this year. Multifamily starts have been especially weak -- single-family units also declined last month in response to recent increases in home prices and mortgage rates. Furthermore, reports from the field of declining traffic, lower sales, and very weak housing permits in May, indicate that further declines in starts are likely over the next several months.

6. The trade deficit improved to between $13 and $14 billion in March and April from approximately $15 billion in February -- in real terms, the decline was even larger. However, the upturn in exports continues to be relatively mild -- furthermore, some of the slackening of imports seems to be related to softness in demand.

7. Orders for nondefense durable goods continue to zigzag on a monthly basis, but the trend remains only modestly upward -- this largely reflects the slowdown in domestic demand for big ticket items.

On balance, therefore, the recent data indicate that the economy is still somewhat sluggish, despite the magnitude of the first-quarter GNP increase, and that the situation is not likely to change during the next few months. Data currently

available indicates that the rise in GNP in the second quarter in real terms was 1% or even less, so that economic growth during the first-half of this year averaged only slightly above the near 2.5% average since mid-1984. The mixed data also indicate that a significant pickup is not likely during the months ahead -- in fact, overall economic growth will probably be lower in the second half of the year than it was in the first.

Recent data also indicate that some of the shifts in the performance of different sectors which began late last year are continuing. In particular, as mentioned earlier, the trade deficit (especially in real terms) is continuing to decline gradually, but domestic demand remains relatively weak. The most encouraging news was the relatively large 0.5% increase in industrial production in May -- while this reinforces the view that at least a moderate improvement in the manufacturing sector can be expected because of better exports and slowing import penetration (although the effects are not being spread evenly among specific industries), the May increase overstates the underlying rate of improvement:

1. While manufacturing is, and will continue to, benefit from better trade patterns, I believe that the turnaround in the trade deficit will continue to be slow and gradual, especially in view of still weak economic conditions in much of the rest of the world, and the continuing shift of U.S. trade with the undervalued-currency countries in the Pacific Basin and elsewhere.

2. Domestic demand for big ticket consumer durables and various types of business equipment is likely to remain sluggish. Furthermore, slower growth in defense spending, and weak construction, will also hold down some goods-producing industries.

3. Despite already sizable production cuts, auto inventories remain relatively high (and, in fact, have increased further in recent weeks) as a result of very weak sales. Thus, additional production cuts are likely in the months ahead -- this will not only reduce motor vehicle production, but will feed through into numerous other industries as well.

Even with the pickup in industrial production, overall economic growth will be very moderate for the rest of this year because of the weakness in consumer spending and housing now underway.

THE CAUSES OF SLOW GROWTH

In my judgment, this period of slow economic growth now underway is likely to persist for many years, reflecting: **(a)** some major sectoral changes that are limiting economic growth relative to previous trends, **(b)** the absence of traditional cyclical factors that could stimulate faster growth, and **(c)** the neutral to somewhat restrictive economic policies that are likely to prevail for the immediate future. In my view, it is predominantly the secular forces (primarily the deterioration in U.S. competitiveness in world markets) which are limiting economic growth.

Sectoral Influences

1. U.S. Competitiveness: I believe the major factor affecting the U.S. economy today is the change in U.S. competitiveness in the last ten or fifteen years. U.S. productivity and technology advantages were so large during the early postwar years that the United States was able to maintain dominance in world markets, and generate large ongoing trade surpluses, despite funding much of the free-world's defense, despite having very open markets, and despite cultural and trade barriers which limited access to some other markets. However, even though U.S. manufacturing has remained relatively stable as a share of GNP, these basic advantages have been narrowed dramatically, primarily by rapid productivity growth among traditional foreign competitors, and by the emergence of many highly productive new competitors in the last 15 years, reflecting : **(a)** the speedier transfer of U.S. developed technology to the rest of the world, **(b)** a more rapid rate of new innovation in many other countries than in earlier years, **(c)** a strong emphasis on product quality and design, **(c)** high saving and investment rates, **(e)** the rebuilding of World War II ravaged infrastructures with the most modern equipment (and the use of such equipment in the NIC's), **(f)** the increased mechanization of agriculture, **(g)** the lower base from which many foreign countries started, and **(h)** an emphasis on rapid growth, both domestically and in exports, in order to generate the higher profits necessary to fund additional investment, and research and development. During the same time, productivity growth in the United States was slowing relative to the earlier postwar years.

The net effect of these factors has been to dramatically narrow the differences in productivity and product quality which existed previously between the United States and older competitors, at the same time that a large number of new, highly

efficient competitors emerged -- in fact, average productivity levels in many tradable goods industries are actually now higher in Japan and some other countries than they are in the United States (although not on an overall economy basis, because U.S. productivity levels remain higher in various other industries). As a result, relatively high wage and capital costs in the United States can no longer be justified by productivity differences, and represent an enormous competitive disadvantage -- the combination of these developments has caused a rapid shift away from U.S. dominance in world markets, with sharp declines in the U.S. world-market share for most manufactured and agricultural goods, massive trade deficits, and rapidly growing foreign debt. These trends have been aggravated by the enormous U.S. budget deficits and the overvalued dollar of recent years, by slow growth overseas, and by the LDC debt crisis.

The decline in fundamental competitiveness (i.e., in relative productivity), and its likely affect on future economic growth (to be discussed below), have been hidden or unrecognized because of the following:

A) The manufacturing/GNP ratio (in real terms) has remained relatively stable, suggesting that the United States is not de-industrializing. However, the stability of manufacturing output as a share of real GNP in recent years actually further demonstrates the erosion of U.S. competitiveness when it is viewed in the context of the rapid rebound in the demand of manufactured goods (relative to total demand) in the United States, reflecting the large turnaround in consumer durables, the procurement-dominated military buildup, and the tax-incentive-led pickup in investment in the early 1980s. The surge in demand for goods has been so strong that it has prevented the manufacturing/GNP ratio from declining despite the loss of U.S. market shares (and the related influx of imports and slowdown in exports) -- without the change in relative competitiveness, the manufacturing output/GNP ratio would have risen sharply during the 1980s. This also explains why U.S. manufacturing output grew more rapidly than in the rest of the world during the initial stages of the recovery -- the U.S. market, in which the U.S. has a relatively large (but declining) share, has grown much more rapidly than markets overseas. And, of course, U.S. manufacturing ouptut has essentially stagnated since mid-1984. Finally, maintaining a near-stable manufacturing/GNP ratio (the trend at cyclical peaks has actually been slightly negative) over the last 15 years has been possible only in part by a steadily declining dollar relative to most currencies during the 1970s, which offset some of the widening unit labor cost differentials at that time.

B) The U.S. economy has grown more rapidly than most other industrialized countries during recent years -- this is often cited as the primary cause of large U.S. trade deficits. However, while faster economic growth in the Untied States has obviously increased the trade imbalance in recent years, it does not account for the sharp rise in import penetration rates (rather than just import levels), and the decline in U.S. exports in real terms since 1980 (even though economic growth outside of the United States has been positive, although modest). These have combined to cause the sharp decline in the U.S. share of worldwide production in most industries referred to earlier, and in overall world trade, in recent years. Furthermore, the U.S. trade imbalance continued to rise even as U.S. demand and overall economic growth slowed in 1985 and 1986.

C) The onset of massive trade deficits has coincided with large budget deficits, leading many to conclude that the budget imbalance, by pushing up interest rates and the U.S. dollar exchange rate, is the dominant cause of our trade problems. However, as best evidenced by the rapid rate of increase in the U.S. trade deficit with Japan, and the steady decline in the U.S. dollar relative to the yen and other industrialized currencies, our trade problems were developing well before the 1980s. The full extent of underlying deteriorating competitiveness at that time was temporarily masked by the surge in exports to Latin America (financed by unsustainable U.S. bank lending, much of it directly tied to exports), by rising exports to OPEC countries (in response to oil-revenue-financed development and construction programs), and by the relatively weak dollar. Large U.S. budget deficits have clearly made the trade deficits worse in recent years, both by pushing up the U.S. dollar and by directly stimulating demand; however, increasing foreign competitive pressures would have occurred even in the absence of unbalanced U.S. fiscal policies.

The changing relative position of the United States in world markets is, and will remain, the principle factor holding down economic growth in the United States -- furthermore, because this is a secular rather than cyclical change, the consequences are likely to persist for many years. In effect, the conditions which permitted sustained strong economic growth (almost 4% annually) and rapidly improving living standards during the 1950s and 1960s not only no longer exist, but to some extent, are being slowly reversed -- I therefore expect a continuation of slow economic growth as compared with earlier standards. What will change, however, are the ramifications of the competitive problem and its sectoral impacts. In

recent years, it has held down economic growth by limiting gains in manufacturing and by causing large and growing trade deficits -- in the years ahead, the principal effect will be on domestic consumption. This will come about because rapidly growing U.S. foreign debt cannot continue indefinitely -- at some point, the rest of the world will reach the limit of dollar absorption, so that U.S. trade deficits will have to be dramatically reduced. In fact, the United States will likely have to run trade surpluses at some point in order to generate the foreign exchange to service the large foreign debt that will exist -- this implies an acceleration in industrial output in the years ahead.

In my view, a significant additional narrowing of the gap in real wages between the United States and many other countries will be necessary to bring them in line with productivity differentials -- this will stop the downtrend in the U.S. share of world exports and reduce the U.S. trade imbalance over time. In view of the still slow rate of increase in wages and strong productivity growth in many other countries, much of this will have to be accomplished by the following: **(a)** Additional sizable declines in the U.S. dollar, which we expect on a gradual basis during the years ahead. **(b)** Continued wage restraint in the United States, especially as low-wage countries increasingly become the major competitors in more and more industries. **(c)** Continued efforts to improve productivity will be made; however, as in recent years, it is likely that some of these improvements will occur as a result of employment reductions (especially of high-wage jobs) unrelated to improvements in manufacturing efficiency.

These likely adjustments to deteriorating relative U.S. competitiveness will all hold down real wage growth during the years ahead -- in fact, purchasing power is already beginning to stagnate. This, coupled with low savings rates, already high debt burdens, eroding confidence, and other factors, will limit the growth in consumer spending on a secular basis. Growth in the demand for durable goods will be especially sluggish because they are most sensitive to real income and debt levels, and because changes in interest and sales tax deductibility could limit spending on big ticket items. Continued weak economic conditions in the rest of the world, in part because of inadequate fiscal and monetary stimulus, and in part because of the LDC debt crisis and the decline in OPEC oil revenues, will make it even more difficult for the United States to improve its trade deficit in the years ahead, further suggesting that exchange rates and relatively wages will have to adjust, compounding the effect on U.S. domestic demand.

2. **Buildup in Private Debt:** The sharp increase in private indebtedness in recent years is also limiting economic growth by holding down the growth in consumer spending and business investment. The debt burden is particularly troublesome because most of the debt has been used to fund financial transactions and current consumption, rather than new investment, and since much of it has been financed by increased leverage, and by borrowing from overseas (which will draw income out of the U.S. economy in the years ahead).

Cyclical Factors

In addition to the sectoral factors discussed above, cyclical forces are at best neutral, and in some cases are limiting economic growth.

1. **Pent-Up Demand:** A strong surge in spending for consumer durables, other consumer goods and services, and for new homes, since the recovery began has significantly reduced the pent-up demands which existed earlier.

2. **Inventories:** Despite relatively low inventory/sales ratios, most companies are continuing to follow extremely cautious inventory policies. The uncertain sales and price outlook, still high carrying costs, as well as the use of more sophisticated inventory control techniques, is causing business to continue this approach toward inventory management.

3. **Global Economic Sluggishness:** Extremely sluggish growth in most of the rest of the world, especially Latin America, Japan, some major European countries, the Middle East and Africa, is limiting the turnaround in U.S. exports despite the weaker dollar.

4. **Government Expenditures:** Many state and local governments are restraining expenditures as a result of budget pressures resulting from cutbacks in Federal grants in aid and/or weak economic conditions in their states.

Economic Policy

Unlike other periods of slow growth or recession, economic policy cannot be used to stimulate the economy -- in fact, if anything, it is holding down economic growth.

1. **Fiscal Policy:** The enormous Federal deficits of recent years are holding down economic growth by increasing our reliance upon foreign capital (which has made the trade deficits even larger), by holding down investment, and by keeping interest rates relatively high at a time in the recovery process when much lower rates are needed to stimulate stronger growth. The U.S. is now in fact suffering the worst of both worlds -- expenditure restraint and modest tax increases designed to reduce these budget deficits are making short-term fiscal policy somewhat restrictive (especially since a rising share of the deficit is a result of higher interest payments, which have a relatively small multiplier), while at the same time the deficits are still high enough to prevent a sizable reduction in interest rates.

2. **Monetary Policy:** The ability to pursue more stimulative, lower interest rate, policies has been significantly reduced by developments which are largely beyond the control of the Federal Reserve -- these include the extremely high federal budget deficits still in place (the decline in the FY 1987 deficit now occurring significantly overstates the trend rate of improvement); the net debtor status of the United States which, coupled with historically low saving rates, has enormously increased reliance on foreign capital; and the weakened competitive position of the United States in world markets, which is producing a long-term downward bias to the dollar, and upward bias to inflation. As a result, monetary policy is constrained by the potential effects of interest rate changes on the dollar, and on the willingness of foreigners to hold dollar assets, to an extent which has never existed before. Thus, even in a relatively slow growth environment, it will be extremely difficult for the Federal Reserve to ease dramatically. And, even if the Fed does ease and brings down rates, the high debt, overcapacity, and overbuilding environment suggests that the effects on the economy would be very limited.

By the same token, with the still present risk of a worldwide recession and with the burden of both internal and external debt at an all-time high (as well as the still serious LDC debt problem), a dramatic tightening by the Fed also seems out of the question. These conflicting factors have not only neutralized Federal Reserve policy but have essentially made the Fed a follower -- almost without exception, the Federal Reserve has been forced to follow the markets in recent years, rather than initiating major changes in policy. I expect this pattern to continue for the immediate future -- as a result, I expect no significant policy changes by the Fed, and no major changes in interest rates unless the dollar starts to decline sharply again (which could push rates higher), or the U.S. economy slides into recession.

NEAR-TERM OUTLOOK

The combination of the factors discussed above suggest that slow economic growth is likely to continue not only during the remainder of this year, but for the foreseeable future -- in my judgment, an average of 2% to 2.5% growth in real GNP is the best we can hope for as we look forward. As discussed earlier, this reflects: (a) The improvement in the trade deficit will be gradual at best, and will be brought about by adjustments which will further constrain domestic demand. (b) The high debt levels both here and abroad, and worldwide overcapacity and cautious economic policies, are constraining worldwide demand. (c) The economy will not benefit from increased fiscal and monetary stimulus -- if anything, the opposite is the case.

Thus, in effect, the economy will receive a modest boost from the slow turn in trade, but the adjustments to bring that about, plus other factors, will hold down domestic demand to such an extent that overall growth will remain slow. Furthermore, in my view, the risks are predominantly on the downside, so that a near-term recession cannot be ruled out. The major risks are:

1. The possibility of significant additional increases in interest rates if the dollar were to fall further, which would: (a) further reduce the prospects for residential construction; (b) potentially create turmoil in financial markets, thereby causing a collapse in household confidence; and (c) increase the cost of new investment (thus offsetting some of the increase in business investment that is likely to take place in 1988 as a result of rising corporate profits).

2. The possibility of a retrenchment in household spending in view of the relatively weak financial condition of many households.

3. The possibility of continued stagnation, or worse, in the rest of the world economy, especially in view of the relatively conservative fiscal and monetary policies in many other industrialized countries. Weaker than expected growth overseas would add to the recession risks in the United States by further limiting the turnaround in exports, even with the decline in the U.S. dollar.

INFLATION

As reflected in higher long-term interest rates and sharply rising commodity prices, inflationary expectations appeared to intensify earlier this year -- relatively large increases in both the producer and consumer price increases in earlier months also fueled these concerns. In my view, however, while inflation will clearly be higher than it was during 1986 due to the absence of additional declines in food and energy prices, coupled with the effect of the lower dollar on prices of imported and domestically competing goods, a major acceleration is extremely unlikely, as reflected by the following: **(a)** Considerable slack still remains in labor markets and in production capacity in most geographic areas and industries. Furthermore, with both the United States and world economies growing so slowly, it is unlikely that the current slack will be significantly reduced in the immediate future. **(b)** Despite the runup in commodity prices, the underlying demand-supply balance for most agricultural and industrial commodities has not changed significantly -- oversupply conditions still remain. **(c)** As a result of relatively weak demand for oil, coupled with some cheating by OPEC members, the recent runup in the price of crude oil is not likely to continue -- thus, oil prices are likely to be relatively stable for the immediate future, after being a major factor in the relatively large increases in the major price indexes in the earlier months of this year. **(d)** Wage restraint remains the order of the day, especially in those industries that are competing increasingly against relatively low-wage competitors in the Pacific Basin, Latin America and elsewhere. Furthermore, the automatic COLA's in many union contracts have been dramatically cut back during the last several years. Finally, profit margins are so low in most industries that rebuilding those margins appears to be the first priority of those companies before they will consider significant increases in wages. As a result, it is unlikely that wage increases will accelerate to such an extent as to trigger a wage-price spiral, as frequently occurs when an outside factor causes inflation to accelerate.

As a result, I expect inflation to actually moderate during the rest of the year, but that it should remain in the 4% to 4.5% range as measured by the CPI for the next several years. While this is substantially above the artificially held down rate during the last couple of years, it nonetheless should not precipitate a policy response which could result in weaker growth.

FEDERAL BUDGET OUTLOOK

There seems to be a major disagreement currently regarding the causes of current enormous budget deficits, and the outlook for the deficit. I believe the enormous budget deficits of recent years were caused primarily by the combination of the military buildup and the tax cuts enacted in 1981. Projections of a balanced budget by 1984 were highly unrealistic from the start because of the very optimistic economic assumptions, and large unspecified spending cuts, they were based on. The federal deficit has continued to rise in recent years, despite new spending cuts, partly because of the enormous growth in interest payments (reflecting insufficient deficit reduction in prior years). In effect, the Congress has adopted spending cuts, only to find that future deficits were higher than expected because the economy did not perform as favorably as assumed, and because of the "snowball" effect of rising interest expense.

In my judgment, large budget deficits cannot be blamed on the budget process itself. The fundamental problem has been the inability or unwillingness of policymakers to accept the dimension and seriousness of the problem, leading to the use of unrealistic assumptions rather than real actions to reduce projected deficits.

Although the FY 1987 Federal budget deficit will be less than previously expected (about $170 billion), the outlook for FY 1988 and beyond has worsened somewhat as a result of higher interest rates, slow economic growth, expected revenue declines from tax reform, and the impact of higher inflation on spending for indexed programs. This year's deficit is lower than expected because of the surge in capital tax revenues reflecting the change in the tax laws -- some of this is being borrowed from future years. Thus, unless the budget deadlock is overcome, there is a strong chance that the federal deficit in FY 1988 will exceed the FY 1987 deficit.

POLICY RECOMMENDATIONS

As indicated earlier, additional actions will be needed to bring future deficits down. However, an approach that will enable us to bring them down in an orderly manner, while at the same time addressing our competitive problem and others, must be put in place. As will be seen below, this will involve a comprehensive re-evaluation of our current budget and other national priorities.

In general terms, I suggest the following approach:

1. Realistic budget targets should be adopted, based on the following guidelines: (a) They can realistically be met. (b) They will not create a short-term risk to the economy (such as strict adherence to the current GRH targets would). (c) They are consistent with the intermediate target of stabilizing the federal debt/GNP ratio by the end of the decade (or 1991). (d) They should be based on realistic economic conditions (average real GNP growth of approximately 2.5% to 3% per year would be my recommendation), since the risks associated with the use of faster growth, by further delaying real action, are too great to bear. As mentioned earlier, a reasonable target under these criteria would be to reduce the deficit by 1990-91 to approximately $100 billion. It is important to note that the actual deficit might be somewhat higher or lower if the economy is much weaker or stronger than assumed -- no offsetting actions need be taken if that were to occur.

2. It should be agreed by the Administration and the Congress that all projections of future deficits must be based not only on realistic economic assumptions, but must avoid accounting gimmicks, sale of assets, deliberate underestimates of the costs of various programs, etc. Realistic estimates of future federal expenditures must then be developed consistent with predetermined national priorities. I believe these priorities should include continuing to provide for appropriate national security, improving our competitiveness, maintaining a safety net for those who need, etc.

3. The Administration and the Congress should jointly determine the appropriate level of military spending that is absolutely required for national security in the years ahead. For this purpose, it should be recognized that we no longer have the competitive advantages in world markets to continue to essentially fund the security of the entire free world. The 6% to 7% of GNP that we plow into national defense is not available for capital formation, for research and development, for education, etc. as it is in many other countries. Thus, a realistic military program which provides for sufficient national security without further jeopardizing our competitiveness needs to be established.

4. Our approach to entitlement programs must be re-evaluated. In my judgment, strong consideration should be given to converting many of these programs to means-tested programs. In particular, it should be evident that, in view of our other needs, we cannot continue to spend such a large fraction of our resources on the

aged, while we neglect education and other programs geared toward the young (which will more strongly effect future economic performance). In my view, the only way to provide for a safety net for the disadvantaged and for the elderly that need support, while at the same time addressing our other problems, is to maintain current benefit levels for those who really need them but cut them for those who do not. Changes should be made in these programs in accordance with this principle, and future expenditures should be estimated on that basis.

5. It is important that a comprehensive study be made of our competitive problems, and judgments be developed as to what types of programs can be most effective in rebuilding our worldwide productivity advantages and thus in improving our long-term competitiveness. These might be in the areas of education, research and development, retraining, etc. Adequate funding at the federal level must then be factored into future budget projections.

6. It must then be recognized by the Administration and the Congress that the difference between the deficit target derived from step one, and the expenditure numbers that would be derived from steps three through five, must be made up by revenue increases. In my judgment, there is virtually no way that at least some modest tax increases can be avoided in the years ahead if we are serious about reaching even the modest deficit reduction that I am proposing, while at the same time maintaining a compassionate government, achieving our national priorities and building a stronger economy in the years ahead. In this connection, I strongly urge that any future tax increases be designed in such a way that they do not further shift the tax burden away from upper income groups as in recent years.

In my judgment, it is imperative that the Administration and the Congress work together (a budget summit, if you will) to jointly agree on priorities, on appropriate funding levels, etc. This will require much greater flexibility by the Administration with regard to both defense and taxes than in recent years. A joint approach will also speed up the process by avoiding the current system, whereby the Administration first formulates a budget, which is then essentially dead on arrival, and then the Congress spends many months responding.

THE BUDGET PROCESS

As I mentioned earlier, the current deficit problem is one of arithmetic,

stubbornness, the use of unrealistic assumptions, differing priorities and philosophies, etc. rather than the budget process itself. As a result, I believe that none of the often suggested modifications to the budget process will be themselves help much in resolving the current problem. Furthermore, many have been offered as a "smoke screen" to divert attention from, or shift the blame for, the deficit itself. Thus, I would suggest putting budget reform on the back burner until we address the real problem in order to avoid shifting attention away from it. Once federal budget deficits are reduced to acceptable budget levels, it would then be appropriate to find ways to improve the budget process in order to make budget policy a more effective policy tool on a long-term basis.

GRAMM-RUDMAN-HOLLINGS

These problems with the GRH legislation have by now been discussed many times -- in brief, they include the following:

1. The GRH deficit targets are extremely unrealistic in view of the current starting point. In particular, any realistic effort to achieve the $108 billion target for FY 1988 is almost certain to produce a sizable recession in the U.S. economy. furthermore, the targets are too optimistic for the next several years as well -- it is not necessary to achieve a balanced budget by 1991. A more appropriate goal would be to stabilize the federal debt/GNP ratio, after the sharp increases in the ratio in recent years -- this would come about if the deficit is reduced to approximately $100 billion by 1991. The need to stabilize the federal debt/GNP ratio primarily reflects the fact that a stable ratio will also stabilize future interest payments (relative to GNP) at stable interest rates, and thus stop the upward spiral that could further widen future budget deficits if the ratio continues to rise. While I believe that the budget deficit should be reduced even further on a longer term basis, the above should be the intermediate objective.

2. GRH targets take no account of underlying economic conditions -- thus, even further budget cuts would be necessary to meet those targets if the economy were to weaken, despite the fact that such cuts would weaken the economy further. Thus, GRH eliminates the budget as an automatic stabilizer.

3. Under GRH, the entire burden of automatic sequestration would fall on only a relatively small part of the budget, and revenues are completely off the table.

4. GRH does not discriminate between good programs and bad programs. Mindless adherence to targets is probably already causing some cutbacks in programs that are well run and effective, and in the process, creating unnecessary hardships.

5. As important as cutting the federal deficit is, it is not the only national priority. In particular, unless we address some of our other key economic problems, the outlook is for continued modest economic growth during the next several years. GRH diverts attention from these and may actually be preventing adequate funding for those programs which are important for our future.

Thus, in my judgment, GRH should be scrapped.

Senator SARBANES. Thank you.
Mr. Blinder, please proceed.

STATEMENT OF ALAN BLINDER, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. BLINDER. Let us start with a couple of apologies—first for not having a prepared statement. As I think you know, your staff tracked me down while I was out of the country; and I was invited at rather short notice and did the best I could.

Second, I'd like to apoligize for not having anything very startling to say.

On the other side, I think I will paint a bit more optimistic picture than what you just heard, and that might leaven the morning's proceedings a little bit. I'm going to try to stick fairly closely to the questions you posed in your letter.

As I see it, the outlook for real growth in the economy is much as it has been in the last couple of years. That is to say, somewhat sluggish but—importantly—persistent, continuing growth, featuring very little expansion in domestic demand, while getting most of the growth in this year and probably next from foreign demand.

During the last 6 or 9 months or so, I've been on the optimistic end of the consensus range of forecasts. Early in the year I was looking for something like 3 to 3.5 percent growth on a fourth quarter to fourth quarter basis. That put me out there with the Council of Economic Advisers, which worried me a little bit. But as I rethought it, I decided that such a forecast seemed reasonable, so I would stick with it anyway. I still feel that way.

On a year-over-year basis, by the way, that translates to something rather lower because of the quarterly pattern, something closer to 2.5 to 2.7 percent. I don't know exactly, but something in that range.

The key point to make—and this is the sense in which I am more optimistic—is that 3 to 3.5 percent growth, if we can do it, is not bad at all in the current situation. We have just heard from Commissioner Norwood that the unemployment rate is down to about 6.1 percent. That's the lowest it's been in a long time. According to some economists, that's pretty close to the full employment level of unemployment. I don't think that's right; I think we could push a bit lower. But we are certainly getting into the vicinity where—in an economy with the labor force growing at something around 2 percent, productivity doing less than 1 percent, making the rate of increase of potential output something less than 3 percent—if we can keep output growth at 3 percent or above, we can continue to make small but steady inroads in unemployment, as we have been doing during 1987 and the end of 1986. And I think, in that respect, things look a little better than they did a year or two ago.

On inflation, when I looked at the outlook at the beginning of the year, inflation looked rather tame to me, but bound to accelerate from the abnormally low levels achieved in 1986, for many of the reasons that Larry Chimerine just mentioned.

It did, of course, accelerate. And, as I look at it now, in July 1987, it still looks tame to me. I refer of course to baseline or underlying inflation. There are some transitory inflationary impulses

still to come from increases in import prices due to the falling dollar, maybe even some more from energy, I don't know. But the fundamentals for inflation are very good.

Wage increases are very moderate. There's slack in the U.S. economy and, importantly, there's even more slack in the rest of the world economy. There are gigantic amounts of slack around the world and many of the prices that go into our indices are for world-trade products. A large increase in inflation is just not in the cards.

One thing I wonder about is whether the inflation panic that Larry Chimerine alluded to a moment ago is over. I don't know. I've never been able to predict when panics would come and go. It was clear that there would be some panic over the acceleration of inflation sometime this year. I hope that it's over; but if there is any more of it I think we ought to ignore it.

Let me now talk a little more specifically. You asked about changes in the outlook since January. I listed five such changes on the outline that I've handed out.

First of all, interest rates have mostly been rising since March and I think rising to a surprising extent. I won't say there's no forecaster who predicted that, but I think by and large forecasters were caught offguard by the rising interest rates. I certainly was.

The key question to be asked here is, have we seen a rise in real interest rates or a rise in inflationary expectations?

In the case of short-term interest rates, I think it makes sense for inflationary expectations to have risen because the short-term factors do affect the 3-month or 6-month or 1-year inflation outlook.

The best indices of real interest rates that I know about—and I'm going to come back to this point in a minute—come from Richard Hoey, an economist with Drexel, Burnham, Lambert, who conducts a survey of decisionmakers, people who deal in financial markets for a living, and asked them what they think is going to happen. That survey shows the 1-year inflationary expectation rising about 0.7 of 1 percentage point between March and May. And that's the period in which the interest rates rose.

Now if that's so, then the real short-term interest rate didn't rise, and what we saw was a transitory increase in inflationary expectations, which is therefore less worrisome.

For long-term interest rates, however, the same survey data show no rise in inflationary expectations at all. By long term here, I mean 10 years; there was no rise in the long term, estimated 10-year inflation rate between March and May. And that means that whatever increase in long-term interest rates we saw between March and May—and we saw something like 150 basis points—was an increase in the real interest rate. And that's a substantial increase as historical real interest rates go, which is clearly a negative for investment spending in the United States, both housing and business investment.

If I may be permitted a brief interjection, this confusion in looking at interest rate behavior and trying to divine what they mean goads me into making the argument yet once more for the Government to issue indexed bonds. If the Government had indexed debt—and Lord knows we have enough debt out there that we could have both indexed and non-indexed with no problem at all—

if the Government had indexed bonds which were freely traded in the market, we could read the real interest rate directly out of the financial markets—both at the long end of the yield curve and at the short end. And we wouldn't have to guess any more about whether, when interest rates went up, it was a real interest rate increase, which is worrisome in this context, or a movement in inflationary expectations which is not an increase in real interest rates. I'll be happy to come back to that in the question period, if you like.

The second thing on my list of changes since the beginning of the year is that fixed investment has been extremely weak in the first quarter, both business investment and residential investment. The rising interest rates that I just mentioned no doubt had something to do with that, especially in the case of housing, where mortgage interest rates rose by a rather surprising amount.

Some of this I think, however, is due to tax reform pulling some of the investment into the last quarter of 1986 and therefore showing us a sort of transitory and somewhat illusory slump in the first quarter of 1987. That is, the first quarter of 1987 looked bad because the last quarter of 1986 was so strong.

Hopefully, most of this slump in investment is transitory. If I'm wrong about that, then one has to write down the forecast in a more pessimistic direction. If the first quarter is indicative of what we will see in the next three quarters of 1987, it's going to be a catastrophic year for investment. But I doubt that that's so.

The third change since the beginning of the year is that net exports have done extremely well. Economists, as you well know, have been announcing the coming improvement of the trade balance for some time now. And those of us who have been doing this are just delighted to see it finally happening, not only because we look better, but, more importantly, because it's much better for the economy.

Between the third quarter and the fourth quarter of 1986, real net exports—that's net exports minus imports in 1982 dollars—improved. Specifically, the negative number got less negative by about $15 billion. And between the fourth quarter and the first quarter, the improvement was about $14 billion. And so far as we can tell by the noises now coming out of the manufacturing sector in the monthly data, and so forth, this improvement seems to be continuing. And that's an extremely positive sign. And, I might add, it's the main reason for my rather optimistic forecast of real growth.

However, and this is the fourth thing on my list of changes since the beginning of the year, the exchange value of the dollar stopped falling about May. You can date it different ways depending on what you look at, but something happened in that kind of timeframe. I believe, as do many people, that this was policy induced. That is to say, it was not the free market deciding that that's as far as the dollar should fall, but policymakers—not only in the United States, maybe I should say not especially in the United States—deciding to do what they could to arrest the dollar's fall. And I think that was a mistake.

I think it was a mistake because I believe that the current exchange rate on the dollar is probably not low enough to create a

trade surplus. And we must realize that, because of the foreign debt that we have accumulated in the interim in running these gigantic trade deficits, and are looking at a foreign debt in the neighborhood of a trillion dollars probably by the year 1990 or 1991 or 1992. You can split hairs about a few hundred billion—like $800 billion—but it's going to be some enormous amount of money. We are going to have to pay interest on that, just as the Brazilians and the Mexicans do now—well, just as they are supposed to do on their debts. I presume we will pay; and to do that we will have to run a trade surplus, just like those Latin American countries have to.

That means it's not enough to get back to the trade position we were in in 1980–81, where we had roughly balanced trade. We have to do better than that. It's hard for me, and for many other economists to believe that the current exchange rate will do that for us.

And I'd like to add, in that regard, that if it's correct that the dollar must fall more—which is not a completely uncontroversial statement, but one which I believe is true—that if it's correct, then it's surely better to have the fall come more quickly than more slowly. There are lots of reasons for saying that.

One is that the foreign debt overhang that we will wind up with at the end of this painful adjustment period will be smaller if we rectify the trade situation faster rather than more slowly. And a lower dollar will help do that.

The second has to do with interest rates. If foreign investors have the perception that the U.S. dollar will stay on a gradual downward track for a long period of time, they are going to charge us higher interest rates. On the other hand, if the dollar would suddenly drop to a rate that was perceived in the financial markets as an equilibrium rate—that is, a rate from which there was no necessity for the dollar to fall further—our interest rates could be as low as the interest rates in Germany and Japan. And that could happen quickly, if we got the dollar down quickly.

And third, a point I want to come back to in about 3 minutes, a lower dollar will put pressure on our allies, especially the Germans and to some extent the Japanese, to expand their economies—which would help not only our export markets but more importantly, the whole world's aggregate demand. I will come back to that point in the context of monetary policy shortly.

The fifth change since the beginning of the year that I think, one I just want to mention, is that OPEC has probably held together a little bit better than a lot of people thought they would in January. And that's another negative for U.S. growth and for inflation, though not a big one.

Well, when I add up all of those five changes, it comes to me to be a small negative on the GNP growth forecast from January to July. But the word I want to emphasize is "small." I think it amounts to shaving a few tenths of a percentage point off what a reasonable forecast might have been. So if I were looking for 3.2 percent in January, I'm looking for 3.0 now, something like that. This adjustment is not very large.

You asked in your letter about risks on the upside and on the downside. Let me take the upside risks first because, like Larry

Chimerine, I think those are less important, and conclude on the downside risks.

The main upside risk is that net exports could do much better than the consensus forecast now thinks; and I think that's a real possibility. For example, if we continue to have $14 or $15 billion quarterly improvements in net exports over four consecutive quarters in 1987, the U.S. GNP is going to do a lot better than people are now saying. Furthermore, if we can gain that much in export markets, the higher operating rates in U.S. manufacturing are going to be a stimulus to business fixed investment; and that will also do better than the consensus forecast is now saying.

If all of that works out nicely, we could easily get a year of GNP growth exceeding 4 percent. Now I want to stress that that's the upside risk. I don't believe that will happen, but it is a possibility. That's the optimistic possibility.

Now let me turn to the pessimistic possibility. The first is, of course, the flipside of the optimistic scenario.

Investment could, as I mentioned a few minutes ago, continue to be extremely weak, as it was in the first quarter of 1987. For business fixed investment, I believe that good growth in sales, especially in manufacturing, and increased capacity utilization will bolster investment; so it will not behave as badly in the remainder of 1987 as it did in the first quarter. But, of course, high interest rates or—perish the thought—even higher interest rates than we have now wouldn't help that one bit.

In the case of housing, I think there's at least a reason to think, or maybe I should say hope, that the worst is over. Housing has been battered by the very large rise in mortgage interest rates we had this year. Hopefully, we have seen the worst of it, but we can't be sure and, in general, the housing market is in a precarious situation—which is yet another reason why we don't want to see another 50 or 100 point runup in long-term interest rates. I think that would be a very bad thing indeed.

The second thing on the downside is that foreign demand for our exports could weaken and turn out to be worse than we now think. It could also turn out to be better, which would be wonderful. We want to remember that the rest of the world is not in very good shape. Latin America is in a terrible depression, at the level of the 1930's basically. Europe is in a semidepression, which is only a little bit better than the 1930's. Even the Japanese economy is not doing well lately.

If demand in the rest of the world sags, it could easily, although I think temporarily, wipe out the projected gains in net exports for the United States that ought to be our due because of the lower dollar. That is to say, in the long term, the cheapening of U.S. goods is going to dominate the picture and our exports will improve. In the short term, however, a cyclical downturn in the rest of the world could overwhelm that and we could actually see our trade picture deteriorate in this worst case scenario despite the falling dollar.

In this regard, we would do well to remember that for the last several years it's been the growing deficit in American foreign trade that has basically propped up the rest of the world. Europe has had a depression. It would have been a worse depression if it

weren't for Americans buying their goods. That's not happening any more. The trade is now swinging in our direction. We are now relying on Europeans and Latin Americans, who unfortunately don't have any income to buy our goods. That means we are relying on something that may not be very reliable. We're relying on a boost from foreign demand.

I now want to come back to the point I made about the dollar depreciation. In terms of policy I believe that the best way to spur the Germans—and when I talk about the Germans, I mean the whole EMS, for the German Bundesbank will basically carry the whole EMS area with it—and perhaps also the Japanese into a more expansionary aggregate demand policy is to have the dollar fall more.

The Germans are already suffering severe competitive problems due to cheap American goods. If the dollar falls another 10 or 20 percent relative to the mark, it's going to be devastating to German manufacturers. And I think that, rather than concern with what's going on in the United States, is what might goad the Bundesbank to expand the German economy to save the skins of their manufacturing industries.

Now I come to my last and perhaps most serious downside risk, and this has to do with the possibility—and I'm afraid it may even be the probability—that the new Chairman of the Federal Reserve System, Alan Greenspan, will have to prove himself, prove that he's a tough guy to Wall Street and to the foreign exchange markets, by taking a tight stance on monetary policy.

Now I don't know that that's going to be the case. As I say, I list this under downside risks. But something like that happening is especially likely if any of the following three things happen.

First, the inflation panic that we had a month or two ago comes back and people start saying ridiculous things about a return to 6 or 7 percent inflation.

Second, if the dollar begins to weaken again and the Fed takes strong monetary actions to defend it, which means pushing up domestic interest rates.

Third, and this is of course most germane to the committee's purview, if Congress and the President cannot get together on an agreement to keep the deficit going down. I don't mean meeting the Gramm-Rudman target of $108 billion for fiscal 1988, but keeping the deficit on a downward track, not backsliding into an uptick in fiscal 1988.

So that's my final policy recommendation. I think it's very important that we keep this deficit on a downward track, not meeting the path prescribed in the Gramm-Rudman Act in 1985, but something like the $30 to $35 billion deficit reduction the Members of Congress on both sides of the aisle seem to be talking about recently. There's been a lot of talk about that. There's been an agreement on a budget that the President may not accept. So I don't know if this is actually going to happen. I think it would be highly desirable if it does happen, with the final proviso that the Federal Reserve step in to replace the aggregate demand that is taken out by the contractionary fiscal policy.

And I think I'll stop there.

Senator SARBANES. Well, thank you very much. I thank both of you for some very helpful testimony.

Let me pick up on your last point, Professor Blinder. What would happen to the economy if in fact a fiscal policy were put into place that met the Gramm-Rudman targets?

Mr. BLINDER. Well, I think that would be extremely contractionary. To meet the Gramm-Rudman target for 1988, we would need a $70 or $80 billion swing in the budget deficit. That's on the order of 2 percent of GNP. Even if you don't believe in any multiplier at all, that's still a reduction of 2 percent, and probably a little more, in total demand. And I think that's a formula—unless the Fed steps in vigorously, more vigorously than I imagine they would, with expansionary monetary policy—that's a formula for a recession, I think.

Senator SARBANES. And if we had a recession, what would that do to the deficit?

Mr. BLINDER. The deficit would wind up substantially above the $108 billion that Congress thought they were creating by enacting this budget.

Senator SARBANES. So if you overdid it by trying to reach this goal of reducing the deficit, you would have the contradictory effect of precipitating the economy into a downturn, thereby raising the deficit rather than lowering it?

Mr. BLINDER. Yes. I don't think you would wind up raising it relatively to what it would have been without the tight fiscal policy, but certainly raising it a lot relative to whatever number would be in the budget resolution, like $108 billion.

A rough rule of thumb for the current size of the economy, I think, is that every extra point of unemployment is about $30 billion of greater deficit. So if we boost the unemployment rate in a recession 1.5 or 2 points, you're talking about tacking $45 to $60 billion, something like that, on to the deficit due to cyclical factors.

Senator SARBANES. Did you want to add anything?

Mr. CHIMERINE. I agree strongly, Mr. Chairman. If you were to cut spending and raise taxes by $70 billion, let's say, not only would we have a recession, but you would lose back about half of that in terms of the effect on the deficit. So that if you try to get to $108 billion by a package of $70 billion of spending cuts and tax increases, you would still wind up with a deficit of about $140 billion, plus we would have a recession.

Senator SARBANES. Where is the breaking point for this scenario that you outline? That is, you have a restrictive fiscal policy to try to reduce the deficit but the deficit is still so large—particularly if you accept Professor Blinder's notion that Alan Greenspan has to prove himself as the new tough kid on the block—that you also get a restrictive monetary policy, and then both are working to contract the economy and, therefore, precipitate a downturn?

Mr. CHIMERINE. Mr. Chairman, nobody can answer that precisely. I would say you ought to target pretty much along the lines that Alan Blinder described earlier, something like a $25 or $30 billion reduction on a year-to-year basis in the deficit, after adjusting for the state of the economy.

I think there are two benefits to that. First, we would be on the right path toward reducing deficits on a long-term basis. Second, it

would give the Fed one less reason to pursue tighter monetary policy. I hope Alan Greenspan is not going to tighten just to prove himself or, quite frankly, for any other reason right now because I don't see any good reason to do so.

But if there's clear evidence that we have put deficits on a downward track without using optimistic assumptions, or accounting gimmicks, or all the other ways we've done it so far, inflationary expectations should be reduced, and our need for foreign capital will be lessened. As a result, the Fed should be much more willing to pursue a more accommodative, less tight policy.

Senator SARBANES. I wanted to ask a question on the savings rate. It's always pointed out that we have a very low savings rate in this country compared with other countries, particularly Japan, but others are cited as well.

First of all, when that comparison is made, are we talking apples and apples? Are the savings rates that are being talked about comparable when those figures are used?

Mr. BLINDER. I think the answer is that the national statistics that we use do measure things somewhat differently than the national statistics of some other countries. But there have been studies putting the data of different countries on a comparable basis—on an OECD basis, on a United Nations basis—and these still show that the United States is way at the bottom on the list of savers.

Senator SARBANES. What are the reasons for that?

Mr. BLINDER. Well, I wish I could answer that. There's a considerable controversy and a lot of economic research about that.

One reason that's sometimes cited is a sort of catchup behavior. We are, or have been until very recently—I think still are, the richest nation on Earth. If you imagine people saving for a target wealth-income ratio, the people that are already wealthy have to save less than the people who are not wealthy. According to that hypothesis, part of the difference between Japanese rates and our rates is that they are sort of catching up to us in wealth accumulation; and there may be some truth to that.

A very speculative hypothesis—I just don't have any idea how much truth there is to this—is that the way we have been up until now allowing deductibility of all kinds of consumer interest has been an encouragement for the consumer to borrow rather than to accumulate the assets first.

But I think the basic fact is that Americans like to buy things. The U.S. savings rate has been extremely low—not as low as it is now, we're kind of abnormally low right now—but if you look at 100 or 130 years of U.S. history, we've had low savings at the personal level for a very long time. That just may be the way Americans are.

Senator SARBANES. Well, now let me just pursue this and I'll come to you in a moment.

Mr. CHIMERINE. Sure.

Senator SARBANES. Are there special factors that you can identify for the abnormally low savings rate that we are experiencing, as compared to the general trend where our rate is lower than others?

Mr. BLINDER. There's at least one. I don't think it will be a full explanation, but it certainly will push you in the right direction and probably get you at least halfway there. I refer to the very

large increases in wealth that have come to individual stock and bond holders over the last year and a half or longer due to the rise of both the stock and bond markets. This is a very large amount of money; and to the extent that people accumulate wealth by capital gains, they have less of a need to accumulate wealth by abstention from consumption.

Or looking at it the other way, when people get richer in their wealth account, they spend more on goods, given their unchanged income. We've already heard that real wages haven't been doing anything for a long time. So measured saving goes down. I think that's been an important factor; but I wouldn't imagine that it's 100 percent of the story.

Senator SARBANES. Is the distribution of income a significant factor in relationship to how we save? For instance, a country's income may be distributed in essentially a two-class way—very much at the top to the wealthy who then have so much money that they don't have to worry about saving, and then very much down at the bottom where you can't save because you have to spend every penny you're getting in order to just maintain some reasonable standard of living. Does that have a significant effect on the savings rate as compared to a distribution in which there's a much larger middle class that's above the level where they have to spend every penny to have a reasonable standard of living, and yet below the level where they have so much money that they're not given to saving?

Mr. BLINDER. That's a very reasonable hypothesis on its face, and has often been assumed by many people. Unfortunately, the statistical evidence is admittedly weak for the simple reason that the distribution of income in one country, say the United States, just doesn't change that much over time, so you can't get much statistical evidence about what a change in the distribution would do to savings. But within the limits of our ability to answer that question by statistical research, it doesn't look like there's much of an effect of the distribution of income on total savings in the economy.

Poor people can do a surprising amount of "saving" by paying back debts. We don't think of that as savings because it's not wealth accumulation but actually, it is. It's negative wealth decumulation. So the rich people save in conventional ways, while poor people do some saving in these other ways—more than we might suppose.

The administration, I'll remind you, used this argument in 1981 to argue that because—and they were very frank about this—because the thrust of the Reaganomic tax cuts was to disequalize the income distribution, more would be saved. The fact of the matter is, we now know, that personal savings fell after these tax cuts.

Now I would not push the view that the causation went the other way, that by disequalizing the distribution of income we got less savings. I only offer that as evidence to the eyeball that there may not be as much in this commonsense view as it would appear.

Senator SARBANES. Mr. Chimerine.

Mr. CHIMERINE. Thank you, Mr. Chairman.

Let me try to very briefly summarize my observations on the questions you raised.

First, I agree completely that even if you adjust the statistical measures, the saving rate in the United States has been traditionally lower than it is in most other countries.

Second, at the personal level it has gone down significantly in recent years. Some of that I think is the result of changes in the economy. For example, we know that the marginal propensity to spend from interest income and from farm income are quite low, and in recent years, as you know, those two sources of income have shrunk compared to what they were earlier.

I think another factor in the recent decline in the saving rate is the increase in import penetration. Spending for imported goods has increased, which shows up on the spending side, but the income that's being generated from that is in Japan and Korea and Taiwan, not in the United States. So, in a period of high import penetration, the savings rate should recline.

What strikes me, though, is what Alan Blinder mentioned, Mr. Chairman. Ours is a spending-oriented society and I think that the major factor that's holding down the savings rate now is that more and more families are unwilling to cut their living standards even though their income is being squeezed. They are trying to either maintain, or continue to grow, those living standards. This is the natural American way.

I am particularly concerned about the current debate in the Congress about consumption taxes because the argument is being made that we need to stimulate savings by raising excise taxes or other consumption taxes. However, in recent years, we enacted IRA's, we've had the highest real interest rates in our history, we've reduced marginal tax cuts—we've done everything from a policy standpoint that we could to increase savings, while at the same time there has been a shift in the distribution of income toward the upper end, which in theory should raise the average saving rate, yet the personal saving rate has fallen.

I think we're in a situation now where many people are not saving more because they can't, and I think we are going to be very disappointed by the impact on savings if we enact a broad-based consumption tax, or value-added tax. It will not stimulate a significant amount of additional savings. We've done a lot already in that direction and it hasn't worked.

Second, we have already changed the tax structure, in my judgment, in a way that's made it much less progressive. And implementing more of these consumption taxes can—it doesn't have to—aggravate that problem, and I don't think that's what we want to do in the current situation.

So I'm personally very leery of the argument that we ought to be rushing to raise excise taxes and enact a value-added tax or a consumption tax, when the justification being used is that we need more savings in this country, and that this is the way to bring that about.

Senator SARBANES. All right. Let me just touch quickly on one final point and then I'll yield to Senator Melcher.

This is the position we find ourselves in as a consequence of running extraordinarily large trade deficits over the last few years. We have deteriorated in literally 5 years time from the world's largest

creditor nation to the world's largest debtor nation. It's an incredible downrun in the American position.

In the Joint Economic Committee Report, this table is the net asset position of the United States. This year here [indicating] which shows not a bad figure at about $150 billion, is 1981. And this [indicating] is 1986 and we're down to minus $250 billion. Of course, the improvement you're talking about in the annual trade deficit isn't that it goes from being minus to plus, it just goes to being less of a minus. So it's going to improve from minus $170 to minus $140 or minus $130.

The fact of the matter is that we are going to add another $130 to this $250, so this line is going to go down even further. And the next year, even if we get an improvement to $100, which everyone would say is a tremendous improvement in the trade deficit, we are still going to add another $100.

One of you said—maybe both of you said—the prospect is that the debt is going to be at a trillion dollars before it stabilizes. That creates pressure to squeeze our standard of living in order to service that debt and I'm hard put to see how we're going to climb out of that box without passing the country through some kind of wringer. I mean, how is that going to be possible? Is there a scenario that manages to move us out of the debt squeeze without going through that experience?

Mr. CHIMERINE. Let me take a crack at that, Mr. Chairman. I think we both talked about this earlier and, of course, this is the main reason why I am so pessimistic. When I look back 20 or 30 years ago when we had sustainable strong growth in this country—in the 1950's and 1960's I guess average GNP growth was close to 4 percent a year, and living standards were improving consistently and at a relatively healthy and strong pace. To a great extent, that performance reflected, in my judgment, the downward role we had in the world economy at that time, and the advantages we had in the world economy. And to a great extent, those are now being reversed, and they are being reversed in an environment of sluggish worldwide economic growth which only makes it more difficult for us to turn our trade deficit around, so it means more of the burden is going to have to be internally within the United States.

This is the main reason I suggested earlier that we could now be 3 years into what is going to turn out to be a relatively long period of very, very slow economic growth, during which living standards will probably stagnate. I think that's the best we can get because we are giving back some of the earlier benefits—what's happening in Korea and Taiwan and some of these other countries, to some extent, is coming out of our hide.

Second, we've prolonged the problem, or pushed it into the future, by going so deeply in debt in recent years and, as you suggested, that money is not coming free. We have to pay interest and dividends on that, and that just further sucks income out of the system.

Senator SARBANES. The President talks about tax and tax and spend and spend, but what we've been doing is borrow and borrow and spend and spend.

Mr. CHIMERINE. Absolutely. And I think the consequences for our competitiveness are worse. Recent fiscal policies have aggravated

all of our problems. They made the competitive situation much worse, but to get back to your question, I think we will muddle through with slow and erratic growth continuing on a long-term basis, if we are lucky. But that requires that we do lower the deficit on a gradual basis, and that trade deficit does improve gradually to offset the weakness in domestic demand, and that there aren't any big bankruptcies, and that a solution is worked out on LDC debt. These are a lot of big "ifs," and that is why I have said two or three times that, looking out over the next 3, 4, 5 years, we will muddle through with slow growth and stagnant living standards. But it's not inconceivable with the world economy so out of balance now that this whole thing can come crumbling down and we could have a very, very severe recession some time during this next 3, 4, or 5 years.

Senator SARBANES. Mr. Blinder.

Mr. BLINDER. I agree with your sentiments about the inappropriateness of this policy of sort of sucking in as much of the world's capital as we can get our hands on, and not only because it's bad policy for the United States. The reason I say it was bad policy for the United States is that we did not invest it in productive uses that would generate the income to pay the interest. We basically consumed it instead. In a short quip, we borrowed from Japan to buy Sony products, things that are not going to produce the income later to pay back the loan with interest.

It was also bad policy for the rest of the world. By rights, a rich country like ours should be lending abroad, just as when the United States was a poor developing country 200 years ago we were borrowing from abroad and making very good use of the money. So I think it was both bad policy for us and for the world.

To me, the debt overhang doesn't lead to a doomsday scenario, but rather a doleful scenario that goes something like this. We managed to go from balanced trade to a mammoth deficit over a course of about 5 years. If we go back to roughly balanced trade over a 5-year period from 1986 to 1991, or something like that, it's going to mean that the rate of growth of domestic consumption or use of GNP is going to be about 1 percentage point less than that of GNP. So if GNP growth averages 2.5 percent over that 5-year period, the rise in domestic consumption or living standards, so to speak, will only average 1.5 percent. The American people are not going to like that very much, but it's not a cataclysm. Maybe I should have emphasized the first part more. The American people are not going to like that very much.

We've done the opposite in the last 5 years. Our consumption has grown about 1 percentage point faster than our production, and now we're just going to have to give that back. So we have the good stuff, and now we're on the down side of the joy ride.

When we get to the end of this, if it takes about 5 years or thereabouts, we're going to have the huge accumulated debt that you were alluding to—$800 billion or a trillion or something like. That's going to mean that the end of the story is that we for a very long time—and I mean more or less forever, because the debt is so large—are going to have to pay interest to foreigners amounting to something like 1 to 1.5 percent of GNP. It's exactly as if we're in a position where, for every dollar that is earned by an American, a

penny and a half gets taken away and sent abroad instead of going into anybody's pocket. That's going to be the final legacy of the spending binge that we had between 1981 and 1986; and it's not a pretty picture.

Mr. CHIMERINE. Mr. Chairman, could I make one comment. Alan Blinder is right that consumption growth will be considerably less, by 1 percent or something in that range, than production growth in the years ahead, virtually by definition.

But the key question is at what rates? Is it going to be 1.5 and 2.5, as Alan Blinder is expecting, or is it going to be 0.5 and 1.5, or minus 0.5 and plus 0.5, or even lower—and given the policies that are being pursued elsewhere in the world economy, and given the drag being caused by LDC debt, and given the drag being caused by our own indebtedness in the United States, it's not inconceivable that it will be the lower set of numbers rather than the higher set of numbers. I think that's the nub of the question you're asking, and I an concerned about it. I think the risks are more that it could be 1 and 2 or 0 and 1 rather than 2 and 3. And if it is, that's an even worse situation because it implies even declining standards of living and real consumption rather than stagnation. I don't think you can rule that scenario out.

Senator SARBANES. Senator Melcher.

Senator MELCHER. Thank you, Mr. Chairman.

The two of you seem to be agreeing on a broad range of policy and it's quite a contrast to what you recommend as to President Reagan's simplification of the problem by saying that, if we only had a balanced budget constitutional amendment and a line item veto, things would begin to shape up better.

While philosophically I can agree with the balanced budget amendment, I don't kid myself into thinking that it will have any bearing on what's happening now, also while realizing that the amendment—every version I've seen of it—carries with it the escape clauses that allows Congress to respond to whatever the needs are at a particular time. With the line item veto, I can well imagine, if the President had that authority, he would be using that to cut $50 million here in soil conservation in one area and $88 million somewhere else on clean water or something like that and plunking $150 million back into Star Wars or shipping it off to the Contras in Nicaragua.

I hope you're right, Professor Blinder, that we have about a 3 percent growth this year. If that is an indication of real growth that would be sustained in 1988, I would feel much more comfortable.

At the same token, Mr. Chimerine, I would hope there's at least 2 to 2.5 percent real growth this year, from the fourth quarter of last year to the fourth quarter of this year, and that that meant we could count on some real growth continuing into 1988.

You said you were pessimistic. You said you were so pessimistic. Well, how pessimistic? Some degree of pessimism?

Mr. CHIMERINE. Well, I don't know if I used that word. Put it this way: I'm less optimistic than Alan Blinder and some others. But my real worry is that the risks over the next 18 months are largely on the downside. I see a much larger chance of a significantly smaller number than I do a much bigger number.

Senator MELCHER. Are you more bearish than a teddy bear?

Mr. CHIMERINE. Than what? I missed that.

Senator MELCHER. Are you a bear? Is your viewpoint bearish?

Mr. CHIMERINE. I think I'm realistic. I don't characterize myself as bearish or bullish, or optimistic or pessimistic. I think I'm a realist.

Senator MELCHER. So you're cautious.

Mr. CHIMERINE. I think the economy is out of balance. I think we've done some—I have to be careful of the word I use—but we've done some things that were very ill advised in recent years in Washington, particularly in 1981. I think we are now paying the price for that.

In addition, I think that some of the conditions which existed back in the 1950's and 1960's, which coincided with rapid growth in this country, no longer exist and, in fact, are being reversed to some extent.

So in that sense, I guess I'm bearish compared to the performance we used to have in this economy.

Senator MELCHER. Well, I'm a whole lot more bearish than you are, but it's out of fear. I told somebody I wasn't just an old black bear, I was a grizzly bear. I'm really afraid of what's coming. The credit card comparison—we really have been spending on a credit card binge and you have to pay that off eventually.

As to means testing, Mr. Chimerine, you were speaking of means testing for Medicare and Social Security benefits?

Mr. CHIMERINE. Yes, and quite frankly, Senator, probably some agricultural programs as well. I think we have to look at the whole range of entitlement programs where we've made very little progress in recent years in cutting. We can't afford them all any more.

As I look at what's happened with budget policy, there have been some sizable cuts in some of the discretionary social programs, although not as much as the President asked for. You've also cut defense below what the President asked for. It has almost been a dollar for dollar tradeoff between those two. The sources of growth in spending are now the entitlement programs and interest expense, and we're not going to get interest expense under control until we cut the deficits. So on the spending side, I think we have to face up to the entitlements, whether it's increasingly taxing Social Security benefits or instituting a means test for benefit levels for Social Security and for other programs as well. We can debate which vehicle to use, but I think we're kidding ourselves if we believe that in the long term we're going to have responsible budget policy without addressing those programs.

Senator SARBANES. Would you yield for a minute?

Senator MELCHER. Yes, I yield, Mr. Chairman.

Senator SARBANES. In other words, you're going to cut the Social Security benefits to get a contribution toward the deficit?

Mr. CHIMERINE. I'm going to slow the growth.

Senator SARBANES. But that's a self-sustaining system. The American people are willing to carry the tax burden necessary to sustain that level of benefits. The logic of your position is that if the benefits are too high, if there's too much in the trust fund, either the benefits ought to be raised or the taxes ought to be cut.

You have one area in which the people are willing to carry the tax burden to sustain the benefit level. Not only that, they are carrying more than the benefit level because the trust fund is running a surplus.

Mr. CHIMERINE. Temporarily.

Senator SARBANES. And will go on running a surplus. When it seemed to be going into a deficit a few years ago, we were able to adjust benefit levels and tax levels in order to bring it back into balance.

You have a situation in which you go to the people with a rationale, you create a self-enclosed system, and people are willing to carry the tax burden to support the benefits. Now you're going to undermine the rationale for that system. It doesn't make sense.

Mr. CHIMERINE. Mr. Chairman, I disagree with you. I'm not suggesting we cut benefits across the board. I am suggesting that at upper income levels, benefits should not remain where they are currently.

Senator SARBANES. I understand that. But if you're going to run a surplus in the trust fund, the argument then or the rationale on which the American people are paying those taxes is either the benefits should go up or the taxes should be cut.

Mr. CHIMERINE. But the surplus, Mr. Chairman, is temporary. It will disappear early in the next century when the demographics shift. I can make an equivalent argument about every other program in the Federal budget, Mr. Chairman. The point is, we have to do something about the budget deficit and my own personal view is we ought to make the cuts where they are least painful, regardless of whether the programs are separate or not.

Senator SARBANES. Would you put on a payroll tax to support the other items in the Federal budget?

Mr. CHIMERINE. No, because I think the payroll tax is too regressive.

Senator SARBANES. That's right. But the people are willing to carry that regressive payroll tax in order to support the retirement and health benefits embraced within the Social Security program. So it seems to me when you have a system that people are prepared to sustain which is not contributing to the deficit—in fact, in current circumstances, it is helping to offset it—that to undermine the rationale for the system is just crazy.

Mr. CHIMERINE. I would say, Mr. Chairman, that people will be more willing to have benefits cut back, or frozen, for upper income individuals than they would be to pay additional taxes to fund other programs that we are now spending for. It's a matter of choice. There are no easy answers at this point and I understand that. My own personal preference is that there would be less pain and hardship associated with scaling back benefits at upper income levels in some of these programs than there would be in some other areas.

Second, I think we are underfunding programs that are vital to the future of this country, whether it's education or whether it's job training or other areas, and——

Senator SARBANES. Well, I won't quarrel with that. All I'm saying is I think it's madness to go to the Social Security system to try to fund the money when the system is running a surplus, not a

deficit, and people are willing to take that tax burden, which is a regressive tax, in order to sustain the benefits and maintain that system.

I apologize to my colleague.

Senator MELCHER. You have added to the dialogue and added to the consideration of the problem. I very much appreciate it, Mr. Chairman.

There are three points that seem to be neglected. At least I don't hear them discussed by either one of you or for that matter others who look at our current situation and try to dope out what would be the best steps for Congress to take.

One of them is in the whole discussion of means testing versus Social Security and Medicare and what have you, nothing has been mentioned by either one of you today nor have I seen any proposal of any nature either from Congress or the administration on this basic question. Is the cutoff at $39,000 for Social Security and Medicare contributions or taxes—is that proper? Should it be raised? Because obviously it would generate more funds and, as a matter of fact, the argument can be made, at least among Senators and Congressmen and Congresswomen, that we could afford it.

Mr. BLINDER. I personally think that if we're going to raise more tax revenue—and I think we are in the next Presidential administration, whoever the President is—I can think of a lot worse ways to raise it than what you just said. I think that would be on the list of things that deserve serious consideration.

But you have to realize it does get away from the earned-right principle that Senator Sarbanes was just appealing to. The cutoff of the taxes is related to the cutoff of the benefits; they are tied by formula, and one needs to break that formula. But I think one could make a coherent argument to raise the taxes only on the upper income, especially for funding what amounts to the means tested portion of Social Security.

Senator MELCHER. Yes, but that formula does not carry with it this question of, all right you contribute more so you get more on two segments of that 7.15 percent contribution, the tax, neither disability or Medicare. That's a separate item and that's about 2.5 percent of that 7 percent.

Now also, the second point is this. When we're talking about savings in the United States as compared to other countries, I look at this gross tax on earnings up to $39,000 of 7.15 percent as a saving. Why shouldn't it be? It is not savings?

Mr. BLINDER. It's Government savings. Everything that comes into the Government as a tax can be thought of as national savings by the Government. If the Government turns around and spends it, of course, the saving is no longer there. And the major change in U.S. saving over the last 5 or 6 years has been in Government dissaving rather than in personal saving.

Senator MELCHER. Well, it depends upon whether you want to call the trust fund a savings account or not. I think it's the same as a savings. At least in disability it can be drawn out and in that case at any age. Medicare is going to be there if you survive long enough, as is the Social Security benefits.

The third point I have is, I think both of you recommend or at least scope it out as part of the big problem is how you arrive at a

budget arrangement that isn't too bad, defense spending, but nobody brings up the point, at least among economists—I guess perhaps because it's a policy decision that Congress has to make—that you ought to—what about this saving defense for the United States by forcing Europe to pay more of their costs, Japan and Korea to pay more of their expense costs? As we get it from the Pentagon, those are extremely significant amounts. It's about $70 billion a year that they say out of defense spending goes to Europe and another $60 billion of defense costs of the United States is really for Korea and Japan. I know the system the Pentagon uses to arrive at those figures. I don't happen to agree with them because we would not have the type of savings at all if we didn't send anybody to Europe or if we didn't have anybody in the Pacific, but we could save significant amounts if we force them to pay more of their share.

Mr. CHIMERINE. Could I comment on that, Senator? I think you have to take the situation 20 or 30 years ago as a starting point. We were so productive relative to everyone else, and so far advanced relative to everyone else, and so far ahead of everyone else in terms of technology, that we could afford to spend 6 or 7 percent of our GNP while the others were spending just a couple percent, and yet still compete very effectively, still grow our living standards and so forth.

I think we have to realize we don't have those advantages any more and, as a result, 7 percent of GNP for national defense becomes a burden on the economy. To the extent the Japanese are spending 1 percent, that difference is going somewhere else. Some of it is going into research and development, and new investment which helps their competitiveness. In a more equal global environment, defense becomes a burden on the economy.

And whether that means we ought to shift some of our costs over to them is an issue you have to wrestle with, but it seems clear to me that it is having a negative effect on productivity performance, and on potential economic growth in the United States relative to the rest of the world. That issue has to be addressed as part of an overall solution to our problems.

How we get there is your job. Nonetheless, I agree with your basic discretion.

Senator MELCHER. It is indeed our job, but I think it has to be part of the discussion that we are in right now when we talk about how much money are we going to spend per year. That's a big item. I thank you both very much.

Thank you, Mr. Chairman.

Senator SARBANES. If I could just follow up on that, it sems to me clear that Japan and Germany in particular are not carrying responsibilities commensurate with their economic strength internationally in terms of contributing to a growing world economy, and that the United States, which is spending over 6 percent of GNP on defense—which some of us argue is too much—is clearly going to spend much more than the 1 percent of Japan. Some want to make Japan into a military nation to address that.

It seems to me there's another route you can go, which is to say that Japan needs to circulate worldwide some of those large current account surpluses which they have been accumulating—for in-

stance, to help address the problem of Third World debt, and on a multilateral basis so they don't tie it to their own trade pattern.

If they could help get growth moving again in the developing world, that would be significant for them and for us. It would help us to address some of our problems. I think that should have been on the agenda at the Venice Summit.

Mr. CHIMERINE. I agree with you.

Senator SARBANES. If you're really going to start talking about what has to be done, you have to start recognizing the burden the United States is carrying and the changes over the postwar period. The technology gap—we've lost that. We no longer have that enormous gap between the level at which we produce and the level at which they produce. It's very close. That's what should have been on the agenda of the Venice Summit if we really want to start trying to get the world economy back into proper perspective. The United States can no longer do it all and it ought not be expected to do it all. The Japanese are putting 1 percent of their GNP into defense. If we put 1 percent of our GNP into defense instead of 6.5 percent, imagine what we could do in terms of our economy.

Senator MELCHER. Mr. Chairman, I think you have properly stated it, but I don't believe there's any more pertinent time to be discussing this and what effect this has on the overall economy than right now when we're putting our Navy in the Persian Gulf in order to make sure that there's continuous production and exportation of Saudi and Iraqi oil, much of which is going to go directly to Japan and Korea. But certainly the question of national defense and the economy of the country—and I say that for all free world countries—they do mix together and the very significant thing that's going on right now dramatizes that.

Senator SARBANES. That's right. Japan gets 60 percent of their oil supply out of the Persian Gulf. We now are going to provide, under the administration's approach, the protection for that oil supply, which means risking lives and spending lots of money.

This is a chart in the annual report of the Joint Economic Committee of nondefense R&D as a percent of GNP. This is research and development which is essential to maintaining your technological edge. This is nondefense research and development. These lines [indicating] are Germany and Japan as a percent of GNP. This line down here [indicating] is the United States. I submit that that gap explains a lot about our difficulty in competing. It's engineering. It's design. It's all of the things that go into these consumer products—people saying, well, they would rather take these imports than our own home produced products, and there's one of the problems.

We ran a table in here showing the Federal spending which the President always talks about. He wants to cut spending. Of course, he apparently excludes military spending from spending. Well, those are the lines. The line that's shot up, that's military spending. This line, which is pretty well leveled out, is civilian spending. There's another problem.

Mr. CHIMERINE. Mr. Chairman, could I make one quick comment on that because I know you have a fundamental disagreement with me, and this is what I was getting to earlier. When I look at our budget priorities, it strikes me that we spend, first, a very large

amount on national defense and, second, of the remainder, an extremely large percentage, quite frankly, is being spent on current consumption, especially for the elderly. A very small percentage of our national budget is being spent on what I call the future—on the young, on investments for the future, on rebuilding the infrastructure, and so forth. What disturbs me is that over the last 4 to 5 years, those are the things we've been cutting. Where spending is growing are, No. 1, military, and, No. 2, in most of the entitlement programs that really go into current consumption and are not building for the future. That's what concerns me, and I think that has to be changed around. Senator Melcher has a terrific point—to the extent we can pass on our defense costs, or at least a portion of them, to somebody else, that would be a tremendous benefit to us.

And second, I personally believe that some of those entitlement areas, whether they're health care or pension benefits or whatever, particularly with the demographic shifts which are going to be pushing those up further early in the next century, that we have to scale those back. And the way to do it is to cut back those benefits for people who don't really need them.

Senator SARBANES. The only point I'm making on the entitlements is that when they carry a tax with them which covers them, you'd better be very careful, because if you go down your path you're going to break the connection. You're going to lose the revenue source and you're going to get less of a contribution toward the deficit question rather than more. That's what's going to happen.

Now if it's an entitlement unrelated to a revenue source, that's a different problem. In fact, those have been squeezed—most of them. That's a different problem. The two trend lines that have changed to produce this large deficit since 1981 are, one, the increase in defense spending and, two, the turndown in revenues, which are of course the two factors the President doesn't want to address in trying to deal with the deficit.

Mr. CHIMERINE. I'm aware of that.

Senator SARBANES. Well, thank you both very much.

Mr. BLINDER. Thank you.

Mr. CHIMERINE. Thank you.

Senator SARBANES. The hearing is adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

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